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No.

SUPREME COURT, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

LEONARD BRAWER,

Petitioner,

vs.

THE OPTIONS CLEARING CORPORATION and AMERICAN STOCK EXCHANGE, INC.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

A. ARNOLD GERSHON
A. ARNOLD GERSHON, P.C.
Attorney for Petitioner
295 Madison Avenue
New York, New York 10017
(212) 684-3033

QUESTIONS PRESENTED FOR REVIEW

When a securities exchange and its clearing house violate their own rules, rules required by a statute that protects investors even in the absence of fraud:

1. Does an investor who is injured by the violation have a claim under the statute?

2. If he has such a claim must he make a showing of fraud or bad faith in order to maintain it?

3. Does he make a sufficient showing of fraud or bad faith to defeat a motion to dismiss where the court finds it a troublesome and close question whether the defendants' conduct was in good faith?

PARTIES TO THE ACTION

Petitioner Leonard Brawer is an individual investor who was injured by the conduct of the respondents.

Respondent The Options Clearing Corporation ("OCC") is a Delaware corporation and is a registered clearing agency under § 17A of the Securities Exchange Act of 1934 (the "Act"). Respondent American Stock Exchange Inc. is a New York corporation and is a registered national securities exchange under § 6 of the Act. Each respondent is a self-regulatory organization ("SRO") under §§ 3(a)(26) and 19(g)(1) of the Act. A-5, 17.

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LEONARD BRAWER,

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PETITION FOR A WRIT OF CERTIORARI TO
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In this action to recover damages against a securities exchange and its clearing house for violating their own rules, under §§ 6(b), 17A(b)(3), and 19(g)(1) of the Securities Exchange Act of 1934, petitioner Leonard Brawer, plaintiff-appellant below, prays this court for a writ of certiorari to review the judgment of the Second

Circuit entered December 11, 1986 and the order of the Southern District of New York dated April 29, 1986.

OPINIONS BELOW

The opinions of the Second Circuit (A-1) and of the Southern District of New York (A-15) are reported, respectively, at 807 F.2d 297 and 633 F. Supp. 1254.

STATEMENT OF JURISDICTIONAL GROUNDS

The judgment of the Second Circuit (A-54-55) was dated and entered December 11, 1986. By order of January 9, 1987 the Second Circuit allowed the late filing of a petition for rehearing. (A-56). By order of February 11, 1987, the Second Circuit denied the petition for rehearing. (A-57-58). The jurisdiction of this court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS AND RULES INVOLVED

The relevant provisions of the

statutes and rules involved are reproduced in the appendix. Section 6(b), 15 U.S.C. § 78f(b), is at A-50-51, as it was originally, and at A-3, as it has been since the Securities Acts Amendments of 1975 (the "1975 Amendments"). Section 17A(b)(3), 15 U.S.C. § 78q-1(b)(3), is at A-3-4. Section 19(g)(1), 15 U.S.C. § 78s(g)(1) is at A-4. Section 11 of article VI of the bylaws of OCC is at A-49-50. Rules 902 and 903 of the Rules of the Board of Governors of the Annex are at A-48-49.

STATEMENT OF THE CASE

On Friday, March 1, 1985, petitioner Brawer was holding short positions in listed put options on the stock of Phillips Petroleum Company ("Phillips"). These options were traded at the market of respondent Amex and cleared by respondent OCC.

Before March 1, Phillips had proposed a refinancing plan which it denominated a recapitalization, and the Amex and OCC had announced that the Phillips options would be adjusted if the stockholders approved the plan. However, the plan failed to win approval. Next, over the March 1, 1985 weekend, Phillips proposed a second plan that would have an even greater effect on its capital structure, but both plans had an extraordinarily substantial effect. Before the recapitalization, Phillips had a debt equity ratio of one to three. The first plan would have turned it around to three to one. The second plan changed it to four to one. The second plan succeeded, but the Amex and OCC failed to adjust. A-5-9. Their sole reason given was that the second plan was actually an exchange offer for which

no adjustment was required, rather than a recapitalization for which it was. A-8.

Adjustments are required as provided in OCC bylaws, article 6, §11. See A-49-50. The purpose of the adjustment rules is the protection of investors. They are, in substance, an expanded form of anti dilution rule as is found in convertible bond indentures and the instruments governing stock purchase warrants and convertible preferred (or common) stock. Anti dilution provisions are designed to protect persons who invest in warrants and convertibles. Without them there is no protection. The American Bar Foundation, Commentaries on Indentures, at p. 527 (1971) explains it succinctly:

> The anti-dilution provisions are designed to preserve the value of the conversion privilege against

diminution by certain voluntary corporate acts. For example, if the conversion price is $25 a share at a time when the common stock has a market value of $30 a share, the conversion right is clearly valuable. If the Company should then split its stock 3 for 1, the market price of its shares would be reduced to approximately $10 per share. Thus the value of the right to convert at $25 per share would have been virtually destroyed, by that voluntary corporate action, in the absence of appropriate protective provisions.

Inasmuch as ownership of a convertible debenture does not give the holder the rights of a shareholder, the holder of a convertible debenture would have almost no protection against acts by the Company which would adversely affect the value of the common stock issuable on conversion, such as a split-up of shares, stock dividends, distribution of assets, issuance or sale of other convertible securities, issuance of options, issuance or sale of common stock at prices below the current conversion or market price, merger, sale of assets or dissolution and liquidation of the Company. Events of this type are customarily described as "diluting" the value of the conversion privilege, and if protection is desired against such dilution, appropriate provisions must be included in the indenture.

[Footnote omitted]

The major difference between the anti dilution provisions just described and the adjustment rule for listed options is that the former seek to protect the holder of what is, in substance, a call, and the latter seeks, by its terms, to protect the writers as well as the holders and as to puts as well as calls.

Brawer was damaged because the recapitalization would cause a decline in the market price of Phillips stock, as Phillips had said. In anticipation of the decline in the price of the stock, the price of the puts rose, and since Brawer was short puts he lost. This technical description should not obscure the fact that what Brawer had done, in substance, was to agree to buy Phillips stock, at the option of the seller, at a fixed

price. As a result of the recapitalization and the SROs' failure to adjust, he became burdened with the duty to buy stock which had become diluted, but he had to pay the same price as if no dilution had occurred. I have estimated such damage to the entire short put class as approximately $15 million.

Brawer sued under §§ 6(b), 17A(b)-(3), and 19(g)(1) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq. (the "Act"), relying principally on Baird v. Franklin, 141 F.2d 238 (2nd Cir.) cert. denied 323 U.S. 737 (1944) for the rule that an implied claim exists and that it is governed by a negligence standard.

The jurisdiction of the District Court rested on § 27 of the Act, 15 U.S.C. § 78aa. The jurisdiction of the Second Circuit rested upon 28

U.S.C. § 1291.

The defendants below answered the complaint and served motions to dismiss. The grounds for these motions were that there was no private right of action under the Act to redress the wrongs alleged in the complaint and that such an action could not be maintained without a showing that the defendants had acted fraudulently or in bad faith. In their moving papers the defendants stated that they had not acted fraudulently or in bad faith. In order to test these assertions, the district court allowed the plaintiff to take two depositions limited to the bad faith issue.

The District Court dismissed the complaint on the grounds that no private right of action existed. It held that the action previously allowed by Baird v. Franklin had not been

preserved in the 1975 Amendments. It did not reach the fraud issue.

The Second Circuit expressly declined to rule upon the issues that served as the basis for dismissal by the District Court. Instead, it affirmed on the grounds that the action could not be maintained in the absence of allegations of fraud or bad faith and that Brawer had failed to make a sufficient showing of either.

In the course of its opinion the Second Circuit held that the conduct of the Amex and OCC raised "troublesome" and "close" questions on the issue of bad faith. A-14. Accordingly, Brawer filed a petition for rehearing with a suggestion for rehearing in banc. The Second Circuit denied the petition for rehearing without an opinion.

REASONS FOR GRANTING THE WRIT

This is a case against the most powerful and sophisticated professionals in the securities industry, i.e., the exchanges, clearing houses, and other such groups defined by statute as self regulatory organizations ("SROs"). When SROs act they have the capacity to do great harm. Without the protections provided by the federal securities laws and particularly the provisions involved here, SROs are private clubs run for their own benefit and wholly unaccountable to investors. That such private club status is simply intolerable has been recognized by nearly everyone, and it has been a mainstay of public policy, as embodied in the Securities Exchange Act, for more than fifty years. The necessary function of SROs in the process of capital formation, allocation, and

liquidity is too important to allow them to return to those days of immunity and privilege.

The decisions below have introduced substantial, live conflict upon the question of the standard of conduct required of SROs and, even worse, upon the very question whether an investor is entitled to any relief at all.

There is much public concern these days over the fairness of the conduct of participants in the securities industry, some of whom have lately been found to have acted in cynical disregard of the law and with contempt for the rights of investors. The questions presented in this case go to the heart of that public concern in that they will determine whether and by what standards investors can secure their federal statutory protec-

tions against SROs. In short, this action questions the fairness of the market itself which, as is seen here, is driven not by an invisible hand but by self interested people. Their self interest caused them to be uninformed about important facts and careless in making a decision affecting the investors that the law requires them to protect. As a result of the decisions of the courts below these lords of the market are unaccountable to those very investors.

I

THIS COURT SHOULD GRANT THE WRIT TO RESOLVE CONFLICTS CONCERNING WHETHER AN INVESTOR HAS AN IMPLIED CLAIM AGAINST AN SRO THAT VIOLATES ITS OWN RULES.

This court has never expressed an opinion on Baird v. Franklin, which is the leading case that supports the petitioner's claim. As the District Court noted, it was followed pretty

much by all courts. (A-24-26). In reference to Baird the Ninth Circuit in Hughes v. Dempsey-Tegeler & Co., Inc., 534 F.2d 156, 167 (9th Cir.) cert. denied 429 U.S. 896 (1976), held:

> [Judge Clark's] opinion is recognized as the dispositive analysis of the Exchange's duty and breach of duty under Section 6.

As the Second Circuit noted, there is conflict on the question whether Baird v. Franklin, supra, "remains good law after the 1975 Amendments to the Act and recent Supreme Court decisions." (A-5). In addition to the references of the Second Circuit, there are two other cases worth noting. The Ninth Circuit, addressing the effect of two decisions of this court, Cort v. Ash, 422 U.S. 66 (1975) and Securities Investor Protection Corp. v. Barbour, 421 U.S. 412 (1975), held

that nothing in these cases "mandate[s] a reversal of the longstanding rule that a private action is available under Section 6." Hughes v. Dempsey-Tegeler & Co., Inc., supra, 534 F.2d at 166 n.5. The Third Circuit has disagreed with the Ninth Circuit. See Walck v. American Stock Exchange, Inc., 687 F.2d 778 (3rd Cir. 1982) cert, denied, 461 U.S. 942 (1983).

I submit that Baird v. Franklin was preserved by Congress in the 1975 Amendments. Merrill Lynch, Pierce, Fenner, & Smith, Inc. v. Curran, 456 U.S. 353 (1982). Although the Second Circuit noted that courts were in conflict upon this question, it did not resolve the conflict. (A-5). The Curran rule is applicable here because Congress noted the existence of Baird v. Franklin with approval as it conducted its investigations

which resulted in the 1975 Amendments. See p. 27 n.21 of the Securities Industry Study Report of the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs of the United States Senate, 93rd Cong., 1st Sess. (Committee Print 1973) (the "Securities Industry Study"). Congress declined to enact legislation nullifying Baird v. Franklin, but it did nullify two decisions of the Judicial Panel on Multidistrict Litigation which had ordered pretrial transfer and consolidation, pursuant to 28 U.S.C. § 1407, of SEC enforcement actions with private civil actions. Senate Committee on Banking, Housing and Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. at pp. 73-77, reprinted in 1975 U.S. Code Cong. & Ad. News 179 ("Senate Report"). Congress also expressly stated its

intention to clarify the decision in Rosenfeld v. Black, 445 F.2d 1337 (2nd Cir. 1971). Senate Report at p. 71. Conversely, Congress never said that it wanted even to change, much less abolish, Baird v. Franklin.

The 1975 Amendments codify the principle of Baird v. Franklin and make no change in the statute insofar as it supports Baird. The principle established in Baird v. Franklin is that, since the statute requires a securities exchange to have rules, the exchange must comply with and enforce those rules. Otherwise, the statute would have no purpose.

In its old and new forms §6 requires that a national securities exchange have rules. The reason that Congress changed §6 was to make it clear that exchange rules be capable of protecting investors. See new §6(b)(5). Congress

had expressed some doubt that this was required by old §6. Senate Report at p. 27. The new statute, §6(b)(1), adds that a securities exchange must be able "to comply ... with ... the rules of the exchange," and §19(g)(1) also expressly requires exchanges and, indeed, all SROs to comply with their own rules.

Even without the Curran rule, the petitioner's claim is maintainable under Cort v. Ash, 422 U.S. 66 (1975), as Judge Clark's opinion in Baird v. Franklin is entirely consistent with Cort v. Ash, as at least one court has noted. Rich v. New York Stock Exchange, Inc., 509 F. Supp. 87, 88-89 (S.D.N.Y. 1981). As previously noted, the Ninth Circuit and the Third Circuit have disagreed with each other on this question.

Even before reaching the Second

Circuit's basis for decision this court is presented with conflicting lower court decisions concerning the meaning of a new statute that regulates a substantial and significant industry. In the many years since Baird v. Franklin was decided this court has never ruled upon it, but the lower federal courts followed it almost without exception. Now, however, the lower courts are responding to mixed signals from this court which have, unfortunately, resulted in a lack of clear authority, and they are producing conflicting decisions over the fundamental issue whether an investor even has a claim at all. Accordingly, this court should resolve the conflict.

II

THIS COURT SHOULD GRANT THE WRIT TO RESOLVE CONFLICTS CONCERNING WHETHER AN INVESTOR MUST SHOW FRAUD OR BAD FAITH TO RECOVER ON AN IMPLIED CLAIM AGAINST AN SRO THAT VIOLATES ITS OWN RULES.

A. The Limitations on Discretion Imposed by § 6 Preclude a Fraud or Bad Faith Standard.

The origin of the negligence standard, rather than a fraud standard, is Baird v. Franklin, where the court limited the discretion of securities exchanges not to obey and enforce their own rules and held, 141 F.2d at 244:

> If all that §6(b) meant was that every exchange should pass token regulations, incapable of enforcement except at the wish of the exchange itself, there would have been no purpose for its inclusion in the Act. Sections 6(b) and (d) were surely intended to be read together, and the latter makes it clear that the purpose of the requirements of the former is "to insure fair dealing and to protect investors." This can be realized only if §6(b) is construed as imposing the twofold duty upon an exchange of enacting certain rules and regulations and of seeing that they are enforced.

On the question whether fraud or bad faith must be alleged the Ninth Circuit has held that it need not. Instead, in Hughes v. Dempsey-Tegeler & Co., Inc., supra, 534 F.2d at 170, the court imposed a standard of reasonableness, contingent upon prompt action, taking into account all the facts and circumstances. Reasonableness, I submit, is essentially the same as a negligence standard. The court also held, 534 F.2d at 167:

> "Standing alone, the fact that the Exchange acted in good faith is not a sufficient defense against an action brought under Section 6."

The court was concerned lest a securities exchange be given too much discretion in the matter of enforcing its rules. In any event, if good faith is not a defense, it is unnecessary to allege bad faith.

I submit that this limitation

on discretion was undisturbed by the 1975 Amendments because they only strengthened the protection of investors.

The Second Circuit cited Schonholtz v. American Stock Exchange, Inc., 376 F. Supp. 1089, 1092 (S.D.N.Y.) aff'd. 505 F.2d 699 (2nd Cir. 1974) as authority for imposition of a fraud standard. A-11. There the district court cited Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2nd Cir.) cert. denied, 385 U.S. 817 (1966) and Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir) cert. denied 396 U.S. 838 (1969). These cases impose a fraud standard, but they are expressly and specifically limited to actions against member firms rather than securities exchanges, a distinction the court carefully drew in Colonial. When

the court affirmed Schonholtz it did so on the grounds that no Baird v. Franklin claim could exist "when no rules were violated." 505 F.2d at 700. The court in Schonholtz did not reach the fraud issue in §6 claims.

Although, as the Second Circuit noted, cases against commodities exchanges have imposed a fraud standard, A-10-11, I submit that cases against commodities exchanges are unreliable as precedent for a fraud standard here. The cases under the Securities Exchange Act have consistently rejected a fraud standard. Congress enacted 7 U.S.C. § 25(b)(4) for the express purpose of imposing a fraud standard in cases against commodities exchanges. Even though this merely codified existing law, Congress was well aware of Baird v. Franklin, its limitations on discretion, and its negligence

standard for liability, but it never enacted a fraud standard for liability of securities exchanges as it did for commodities exchanges.

I am not aware of any authoritative explanation of the difference in the standard of civil liability of securities exchanges and commodities exchanges. I submit that there is nothing unfair in the negligence or reasonableness standard and that there is no compelling reason to drive securities investors into the posture of commodities investors, especially where Congress itself has not done so.

A negligence standard is fair when SROs make an erroneous decision as to whether to adjust. It is their market which they have undertaken to manage. They or their members profit from it. Options trading is a significant part of the Amex's busi-

ness, and options clearing is the only business of OCC. The adjustment rule is their rule, and, as Congress believed, investors have the right to rely on proper compliance with that rule. Securities Industry Study, p. 5 (acknowledging "the reliance placed by public investors on the operation of the self-regulatory agencies").

The position of the SROs in this case is substantially similar to that of a depositary in escrow in that both hold other peoples' money for the purpose of delivering it to the right person. The courts treat depositaries in escrow as fiduciaries and impose upon them nearly absolute liability for failure to make a proper delivery or payout. 20 (Revised) N.Y. Jur., Escrows §§ 6, 25. I submit that it is fair to apply the same

principles to the SROs.

No one has taken issue with the proposition that the SROs' decision not to adjust was clear error. Courts have consistently held that a recapitalization occurs when a corporation makes and carries out an exchange offer of new bonds for old stock. Microdot, Inc. v. United States, 728 F.2d 593 (2nd Cir. 1984); Comm. v. Neustadt's Trust, 131 F.2d 528 (2nd Cir. 1942); see Wood v. Coastal States Gas Corp., 401 A.2d 932, 940 (Del. 1979) (a spinoff distinguished from an exchange). No one has taken issue with the proposition that the failure to adjust resulted in the misallocation of approximately $15 million.

I submit that to allow such whimsical, capricious, and disastrous action by SROs strips investors of the protections of the Act. It is no answer

that it simply "benefit[s] one group of option investors at the expense of another." A-12. The chance to win an undeserved windfall is not the protection contemplated by the Act. In such circumstances, the denial of judicial review except for fraud does not reduce market uncertainty, A-12, but merely substitutes one kind of uncertainty, a less acceptable kind I submit, for another.

B. The Limitations on Discretion Imposed by § 17A Preclude a Fraud or Bad Faith Standard.

Section 17A was added to the Act by the 1975 Amendments. Previously, clearing houses such as OCC were regulated as subsidiaries of exchanges. Moreover, although clearing agencies sometimes operate independently of exchanges, OCC is unique and does nothing but clear options and for nobody but the members of the securities

exchanges that trade options. See Securities Exchange Act Rel. No. 20221 (Sept. 23, 1983) 28 SEC Docket 1175, 1196-98. These options exchanges could not function without the OCC, and it is no different from a securities exchange in this regard. See Daniel v. Board of Trade, 164 F.2d 815, 817 (7th Cir. 1947).

Section 17A repeatedly insists upon "prompt" but also "accurate clearance and settlement of securities transactions." Congress declared this to be "necessary for the protection of investors." §17A(a)(1)(A). It also provides that clearing houses must have "the capacity" ... for "prompt and accurate clearance," §17A-(b)(3)(A), and that their rules must be designed to promote it. §17A(b)-(3)(F).

The adjustment rule falls within

regulation by §17A. It is a significant part of the clearing of options trades, because it can change the securities which are deliverable upon exercise of the option.

Congressional concern with accurate clearing means that the adjustment rule must be accurately applied. And whatever discretion SROs might have to interpret some of their own rules as they see fit, in this case such interpretations must yield to the statutory command of accuracy. In other words, an interpretation of the adjustment rule that is not accurate does not meet the statutory requirement. To the extent that the adjustment rule provides for discretion, that discretion is limited by the statutory requirement of accuracy.

The substance of the SROs' adjustment decision in this case exhibits

a distinct lack of comformity to statutory standards. Adjustment was required if Phillips had undergone a recapitalization. I submit that what Phillips did produced a sufficient "reshuffling of a capital structure, within the framework of an existing corporation," Helvering v. Southwest Consol. Corp., 315 U.S. 194, 202 (1942), to constitute a recapitalization. And the method by which this reshuffling was accomplished, i.e., an exchange offer rather than a vote of the stockholders, does not change it. See pp. 25-26, supra.

I submit that the requirement of accuracy cannot be satisfied by mere honesty. It would have been surprising if Congress had said that honesty alone would suffice and had required clearance and settlement merely to be free of fraud or bad faith. The purpose of §17A was to

cure the problems in the late 1960's that prevented "prompt and accurate clearance and settlement of securities transactions." These problems have almost universally been assigned to technical failures rather than fraud. See Senate Report at p. 4, which said:

> The "paperwork crisis" of the late 1960's resulted from the securities and banking industries inability to process the tremendous volume of trading that swept all securities markets. All too often deliveries to customers of both cash and securities were late and stock certificates were lost in the rising tide of paper. Securities firms lost control of their records and over 100 brokerage firms were forced into liquidation -- largely as a result of faulty recordkeeping and backlogs of uncompleted transactions. These liquidations caused financial hardships to many investors who left their securities with brokerage houses for safekeeping. One economic historian recently characterized this crisis as "perhaps the single most dramatic technical failure of the free-enterprise system on record anywhere."

As this case demonstrates, clearing errors can result from causes other

than faulty recordkeeping and backlogs, but there is no reason to tolerate inaccurate clearing whatever the cause. The Second Circuit's opinion does not address the issue of the requirement of accuracy under §17A of the Act.

III

EVEN IF FRAUD OR BAD FAITH IS REQUIRED, THE PETITIONER HAS MADE A SUFFICIENT SHOWING SO THAT DISMISSAL AT THIS STAGE IS IMPROPER.

I submit that where, as here, the court characterizes the question of fraud or bad faith as close and troublesome, then there is sufficient reason to sustain the complaint.

The close and troublesome question, as the Second Circuit held, A-14, was whether the Amex and OCC sterilized their discretion by waiting from early Monday, before trading began, until late Thursday, after it ended, to "decide" not to adjust. During this

period, their staff members had responded to investors' inquiries by stating that no adjustment would be made. This court held that the mere delay, "without more," did not constitute bad faith. Here, however, there was more -- the statements of the staff members that locked the SROs' committee into only one possible adjustment decision. A similar claim of sterilized discretion was held sufficient in Daniel v. Board of Trade, 164 F.2d 815, 818, 820 (7th Cir. 1947). In Daniel the court held that bad faith was sufficiently alleged upon pleading that the exchange adopted a particular rule

> for the added purpose of attempting to protect themselves against the possible liability which might be assessed against them by reason of the anti-trust action which had been brought by Cargill, Inc....

While the Second Circuit stated that

the delay was necessary to enable the committee to marshal information, the delay failed to accomplish this purpose. The record reveals a startling ignorance of the facts by the committee members. They failed to read the prospectus and to discuss the financial consequences, and this should raise more troublesome questions as to just how this decision was made and by whom. The decision to call the committee meeting was not made by OCC's chairman. He could not even say who called the meeting. Where, as here, the proof of how the decision was made is in the hands of the Amex and OCC, "dismissals prior to giving the plaintiff ample opportunity for discovery should be granted very sparingly." Hospital Building Co. v. Trustees of Rex Hospital, 425 U.S. 738, 746 (1976). Only two limited purpose

depositions have been taken, and nine people were present at the March 7 telephone meeting, including one more committee member.

The Second Circuit also overlooked the sharp dissimilarities between Brawer's claim that the adjustment decision benefited the Amex and OCC by generating increased trading volume and revenues and the assertion, in Sam Wong & Son, Inc. v. New York Mercantile Exchange, 735 F.2d 653, 672 (2nd Cir. 1984), that exchange members faced only a remote and theoretical possibility of detriment. In the instant case the fact of increased trading has been shown, and we have also submitted an affidavit of an options broker explaining the connection between the committee's decision and the increased trading. The court sustained allegations of fraud and bad faith

in Daniel v. Board of Trade, supra, upon a showing that I submit was no stronger. Here, following McLain v. Real Estate Board of New Orleans, Inc., 444 U.S. 232 (1980), and Hospital Building Co. v. Trustees of Rex Hospital, supra, Brawer should be permitted to attempt to show the connection between the SROs' adjustment decision and the substantial benefits that they actually reaped.

I submit that the Second Circuit went beyond the limited function of a federal court in deciding a motion to dismiss. In Scheuer v. Rhodes, 416 U.S. 232, 236 (1974) this court held:

> The issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims. Indeed it may appear on the face of the pleadings that a recovery is very remote and unlikely but that is not the test. Moreover, it is well established that, in

> passing on a motion to dismiss, whether on the ground of lack of jurisdiction over the subject matter or for failure to state a cause of action, the allegations of the complaint should be construed favorably to the pleader.

Quoting from Conley v. Gibson, 355 U.S. 41, 45-46 (1957) this court recently held in McLain v. Real Estate Board of New Orleans, Inc., supra, 444 U.S. at 246:

> It is axiomatic that a complaint should not be dismissed unless "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief."

I submit that the Second Circuit went too far in concluding, essentially, that there could be no set of facts that Brawer could present to show that the Amex and OCC sterilized their discretion or acted to benefit themselves by increased trading.

CONCLUSION

The petition for writ of certiorari

should be granted, and the judgments below should be reversed.

Respectfully submitted

A. Arnold Gershon
A. Arnold Gershon, P.C.
295 Madison Avenue
New York, N.Y. 10017
212-684-3033

Attorney for Petitioner

Dated: May 12, 1987

APPENDIX

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 102—August Term, 1986

(Argued October 8, 1986

Decided December 11, 1986)

Docket No. 86-7416

LEONARD BRAWER,

Plaintiff-Appellant,

— against —

THE OPTIONS CLEARING CORPORATION and AMERICAN STOCK EXCHANGE, INC.,

Defendants-Appellees.

Before:

LUMBARD, CARDAMONE, and PIERCE,

Circuit Judges.

Appeal from a judgment entered in the Southern District of New York, Louis L. Stanton, Judge, dismissing

appellant's complaint alleging violations of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78f(b), 78q-1(b)(3), and 78s(g)(1), for lack of a private right of action.

Affirmed.

A. ARNOLD GERSHON, P.C., New York, N.Y., *for Plaintiff-Appellant.*

ROGER PASCAL, Chicago, Illinois (Burton R. Rissman, Joseph H. Nesler, Schiff Hardin & Waite, Chicago, Illinois; M. William Munno, Sewart & Kissel, New York, N.Y., of counsel), *for Defendant-Appellee The Options Clearing Corporation.*

Lord, Day & Lord, New York, New York (Eugene F. Bannigan, Gordon L. Nash, Laurie E. Foster, Monica A. Derham, of counsel), *for Defendant-Appellee The American Stock Exchange, Inc.*

RICHARD A. KIRBY, Assistant General Counsel, Securities and Exchange Commission, Washington, D.C. (Paul Gonson, Solicitor, Daniel L. Goelzer, General Counsel, Jacob H. Stillman, Associate General Counsel, Leslie E. Smith and Katharine Gresham, Attorneys, Securities and Exchange Commission, Washington, D.C., of counsel), *as Amicus Curiae.*

LUMBARD, *Circuit Judge*:

Leonard Brawer appeals from a judgment dismissing his complaint against defendants The Options Clearing Corporation (OCC) and American Stock Exchange, Inc. (AMEX) entered in the Southern District by Judge Louis L. Stanton on April 29, 1986. Brawer's complaint alleges that OCC and AMEX violated §§ 6(b), 17A(b)(3), and 19(g)(1) of the Securities Exchange Act of 1934, as amended (the Act), 15 U.S.C. §§ 78f(b), 78q-1(b)(3), and 78s(g)(1) respectively,[1] by failing to comply with their

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[1]Sections 6(b)(1) and (5), 15 U.S.C. §§ 78f(b)(1) and (5), as amended, state:

> (b) An exchange shall not be registered as a national securities exchange unless the Commission determines that—
>
> (1) Such exchange is so organized and has the capacity to be able to carry out the purposes of this chapter and to comply, and (subject to any rule or order of the Commission pursuant to section 78q(d) or 78s(g)(2) of this title) to enforce compliance by its members and persons associated with its members, with the provisions of this chapter, the rules and regulations thereunder, and the rules of the exchange.
>
> (5) The rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this chapter or the administration of the exchange.

In relevant part, §§ 17A(b)(3)(A), (F), and (G), 15 U.S.C. §§ 78q-1(b)(3)(A), (F), and (G) provide:

> (3) A clearing agency shall not be registered unless the Commission determines that—
>
> (A) Such clearing agency is so organized and has the capacity to be able to facilitate the prompt and accurate clearance and settlement of

own rules. The district court, in an opinion reported at 633 F. Supp. 1254, dismissed the complaint, concluding that Brawer lacked a private right of action. OCC and AMEX, in a joint brief, argue that the district court should be affirmed either on the ground stated in its opinion or on the alternative ground that Brawer failed to allege fraud or bad faith in his complaint. The Securities and Exchange Commission (SEC) also submits an amicus

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securities transactions for which it is responsible, to safeguard securities and funds in its custody or control or for which it is responsible, to comply with the provisions of this chapter and the rules and regulations thereunder, to enforce (subject to any rule or order of the Commission pursuant to section 78q(d) or 78s(g)(2) of this title) compliance by its participants with the rules of the clearing agency, and to carry out the purposes of this section.

(F) The rules of the clearing agency are designed to promote the prompt and accurate clearance and settlement of securities transactions, to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, to foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions, to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency, or to regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this section or the administration of the clearing agency.

(G) The rules of the clearing agency provide that (subject to any rule or order of the Commission pursuant to section 78q(d) or 78s(q)(2) of this title) its participants shall be appropriately disciplined for violation of any provision of the rules of the clearing agency by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, or any other fitting sanction.

The introductory paragraph of § 19(g)(1) of the Securities Exchange Act of 1934, 15 U.S.C. § 78s(g)(1) in relevant part, provides:

Every self-regulatory organization shall comply with the provisions of this chapter, the rules and regulations thereunder, and its own rules

. . . .

brief which urges affirmance on the latter ground. Agreeing with this position, we affirm and hold that a private cause of action against an exchange or a clearinghouse for failure to comply with one of its rules which requires an exercise of discretion, if one exists at all, may be brought only if it is premised upon allegations of fraud or bad faith.[2]

Brawer alleges the following: AMEX, a national securities exchange registered pursuant to § 6 of the Act, 15 U.S.C. § 78f, maintains a market for trading in stocks, bonds and options. All options listed on AMEX are cleared through OCC, a clearing agency registered under § 17A, 15 U.S.C. § 78q-1. Both AMEX and OCC are self-regulatory organizations (SROs) as defined by § 3(a)(26) of the Act, 15 U.S.C. § 78c(a)(26). Phillips Petroleum Company (Phillips), whose stock trades exclusively on the New York Stock Exchange, lists its options on AMEX.

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[2]Accordingly, we express no opinion on two issues argued by the parties on appeal. First, whether *Baird v. Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944), remains good law after the 1975 Amendments to the Act and recent Supreme Court decisions. *Compare Brawer v. Options Clearing Corp.*, 633 F. Supp. 1254 (S.D.N.Y. 1986) (*Baird* no longer remains good law), *with Rich v. New York Stock Exchange*, 509 F. Supp. 87 (E.D.N.Y. 1981) (holding that recent Supreme Court decisions do not eliminate the private cause of action established in *Baird* and arguing that the Congressional silence regarding *Baird* in the 1975 Amendments indicates approval of the then-existing private cause of action under § 6). Second, whether *Baird v. Franklin* may be extended after the 1975 Amendments to support a private cause of action for an SRO's failure to comply with its own rules. *Compare Brawer*, 633 F. Supp. at 1257 n.5 (no significant distinction between the facts of *Baird* and a case where an investor claims that an SRO failed to comply with its own rules) *and Bright v. Philadelphia-Baltimore-Washington Stock Exchange*, 327 F. Supp. 495 (E.D. Pa. 1971) (member stated cause of action against exchange by claiming that exchange had intentionally violated the election provisions of its constitution), *with Lenowitz v. Philadelphia Stock Exchange, Inc.*, 502 F. Supp. 428 (E.D. Pa. 1980) (finding *Bright* no longer persuasive in light of the evolution of the law since that decision).

Brawer sold—in securities parlance "wrote" or took a "short" position in—a number of puts in Phillips stock which were outstanding on March 1, 1985.

A "put option" obligates the seller (writer) to buy shares of the underlying security at a stated price (exercise price), if the buyer (holder) decides to exercise the option prior to its expiration date. Generally, one purchases a put option as insurance. A put option establishes a floor at which the holder will always be able to sell the underlying security; if the price drops below the option's stated exercise price, the holder will be able to invoke the option and sell the securities. On the other side, the option writer essentially takes on the downside risk in exchange for the price of the option. Therefore, if the price of the underlying security falls precipitously, as apparently happened to Phillips stock in this case, the writer may suffer a significant loss.

In December, 1984, a Texas partnership led by T. Boone Pickens, Jr. announced an unsolicited tender offer for Phillips stock. As a defensive tactic, Phillips' board of directors proposed a plan which included the exchange of its own debt securities for 38 per cent of its common stock, the sale of 32 million newly issued shares of common stock to an employee stock ownership plan, and the purchase of the Texas partnership's stock in Phillips at a premium. The price of Phillips stock fell substantially upon the announcement of the plan. The plan did not become effective, however, because it failed to receive the requisite number of votes at a special meeting of Phillips shareholders.

Shortly after this plan was proposed, another hostile bidder for Phillips emerged, led by Carl Icahn of New York. Between the close of business on Friday, March 1,

and the opening of trading on Monday, March 4, Phillips fashioned and announced a second financing scheme. Under this second plan, Phillips would issue a package of debt securities for half of its outstanding common stock. In its offer to purchase, Phillips noted that the likely effect of its offer would be to drive down the price of its common stock. The second hostile bidder withdrew its tender offer in response to this plan.

Both AMEX and OCC have procedures for adjusting option prices in response to changes in the market for an underlying security. AMEX rules 902 and 903[3] make options being traded on AMEX subject to adjustment in accordance with OCC rules. Article VI, Section 11(d) of OCC's Bylaws[4] provides that in the case of a

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[3]Amex Rules 902(a) and 903(c) and (d) provide:

Rule 902.

(a) Subject to the provisions of Rules 905, 907 and 909, the rights and obligations of holders and writers of option contracts of any class of options dealt in on the Exchange shall be as set forth in the rules of the Options Clearing Corporation.

Rule 903. * * *

(c) The unit of trading and the exercise price initially established for option contracts of a particular series are subject to adjustment in accordance with the rules of the Options Clearing Corporation. When such adjustment or adjustments have been determined, announcement thereof shall be made by the Exchange and, effective as of the time specified in such announcement, the adjusted unit of trading and the adjusted exercise price shall be applicable with respect to all subsequent transactions in such series of options.

(d) Option contracts shall be subject to adjustments in accordance with the rules of the Options Clearing Corporation.

[4]OCC By-laws, Article VI, § 11(d) states:

In the case of any reorganization, recapitalization, reclassification or similar event with respect to shares of underlying securities for which adjustment is not provided in any of the foregoing paragraphs of this Section 11, or in the case of any event for which adjustment

"reorganization, recapitalization, reclassification or similar event" affecting the underlying security, "the Securities Committee shall make such adjustments in the exercise price, trading unit or number of contracts . . . as that Committee in its sole discretion determines to be fair to the holders and writers of such option contracts."

Although OCC and AMEX had indicated that they would adjust if the first plan became effective, they made no adjustment in response to the second plan. Nor did they halt trading after the announcement of the second financing plan. When trading opened on Monday, March 4, 1985, the prices of Phillips options rose immediately and steeply as the market responded to expectations of a decline in price of Phillips stock when the plan was implemented. During the following week, OCC and AMEX received numerous telephone calls asking whether they would adjust Phillips options prices in response to the second financing plan. Both OCC and AMEX indicated that no adjustments were likely. The OCC Securities Committee, consisting of two officers of AMEX and the chairman of OCC, held a telephone meeting on Thursday, March 7, 1985, at 3:30 in the afternoon, to discuss the question. They decided that the transaction should be classified as an exchange offer,[5] and, in accordance with longstanding

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is provided in one of the foregoing paragraphs but is not considered by the Securities Committee to be appropriate under the circumstances, the Securities Committee shall make such adjustments in the exercise price, trading unit or number of contracts with respect to the option contracts affected by such event as that Committee in its sole discretion determines to be fair to the holders and writers of such option contracts.

[5]The parties disagree as to whether the second financing scheme should be designated a "recapitalization" or an "exchange offer." Under the view we take, we need not consider this disagreement.

policy, decided not to adjust prices in response. This decision was announced prior to trading on Friday, March 8. Brawer alleges that the Securities Committee took this action because they believed that unadjusted Phillips options would be more useful as instruments of arbitrage, thereby increasing trading volume and the revenues of the exchanges.

In an effort to recover his losses, Brawer commenced this action on behalf of himself and all other writers of Phillips puts who had options outstanding on March 1, 1985. OCC and AMEX moved to dismiss the complaint on two grounds. First, they claimed that the Act does not create a private cause of action for the failure of an exchange or a clearing house to comply with its own rules. Second, they argued that, even if a cause of action existed, a claim that OCC and AMEX failed to comply with their respective adjustment rules could stand only if the complaint alleged bad faith or fraud. The district court granted the motion on the first ground and dismissed the complaint, concluding that the Supreme Court's recent reluctance to imply causes of action under federal statutes, combined with the changes made by the 1975 Amendments, had undermined *Baird v. Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944), and eliminated the private right of action for violations of these three sections.[6] Consequently, it did not consider

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[6] *Baird* held only that an investor had a cause of action against an exchange for its failure to enforce compliance by a member with the Act or the exchange's rules under § 6, as it existed prior to the 1975 Amendments. That section provided in relevant part:

> (b) No registation shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful

defendants' second argument. We affirm because Brawer failed adequately to allege fraud or bad faith.

Brawer asks us to reaffirm the private cause of action established in *Baird* for the failure of an exchange to enforce its rules as required by pre-1975 Amendments § 6, and to extend it to include a cause of action for the failure of an exchange to comply with its own rules under §§ 6, 17A, and 19, as amended. However, here the action involved was discretionary. Courts have consistently held that "absent allegations of bad faith [an exchange and its officials] may not be held for discretionary actions taken in the discharge of their duties pursuant to the rules and regulations of the Exchange." *P.J. Taggares Co. v. New York Mercantile Exchange*, 476 F. Supp. 72, 76 (S.D.N.Y. 1979). We recently reaffirmed this view in *Sam Wong & Son, Inc. v. New York Mercantile Exchange*, 735 F.2d 653, 670 (2d Cir. 1984) ("That bad faith is the standard of liability for suits against an exchange with respect to its taking action authorized by applicable law has been established at least since *Daniel v. Board of Trade*, 164

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violation of any provisions of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.

(d) If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this title and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange.

The district court noted that in this case no member was involved and that Brawer had only alleged that AMEX and OCC had failed to comply with their own rules. However, it concluded that "[t]he distinction does not appear to be significant to the determination whether there is a private right of action under § 6 against an exchange." 633 F. Supp. at 1257 n.5. We express no opinion as to this conclusion. *See* note 2, *supra*.

F.2d 815 (7th Cir. 1947) . . . ."). That these decisions involved suits under the Commodity Exchange Act, 7 U.S.C. § 1 *et seq.*, makes no difference. The bad faith standard expressly established by Congress for Commodity Exchange Act cases in a 1982 amendment, 7 U.S.C. § 25(b)(4), merely codified existing case law under that statute, 735 F.2d at 676 n.30.[7] Moreover, courts have applied the bad faith standard in suits alleging violations of discretionary rules by the securities exchanges as well. *See, e.g., Schonholtz v. American Stock Exchange, Inc.*, 376 F. Supp. 1089, 1092 (S.D.N.Y.) (dismissing complaint because allegations of exchange rule violations were not coupled with claims of fraud), *aff'd*, 505 F.2d 699 (2d Cir. 1974) (per curiam) and cases cited therein. *But cf. Rich v. New York Stock Exchange*, 522 F.2d 153, 155 n.4 (2d Cir. 1975) (noting that the courts apply a negligence standard to claims that an exchange failed to supervise adequately its members).

There are good reasons why a negligence standard has not been and should not be applied to SRO decision-making.[8] First, applying a negligence standard in such cases would force a court to substitute its judgment for that of the experts on the exchange. *See Aronson v. McCormick*, 13 Misc.2d 1077, 178 N.Y.S.2d 957, 959 (Sup. Ct.), *aff'd mem.*, 6 A.D.2d 999, 177 N.Y.S.2d 1004 (1958). In doing so, a court would be aided neither by specific statutory standards nor by any particular financial

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[7]Although *Sam Wong* was decided after Congress amended the Commodity Exchange Act to include an express bad faith standard, the claim being considered in *Sam Wong* arose before the amendment. The court used the amendment as evidence of what Congress believed that the statute required prior to its amendment. 735 F.2d at 676 n.30.

[8]Here, the relevant by-laws obviously gave AMEX and OCC great discretion. Under a different rule, a different sort of duty might obtain. *See Baird*, 141 F.2d at 244.

expertise, *cf. Auerbach v. Bennett*, 419 N.Y.S.2d 920, 926, 47 N.Y.2d 619, 630 (Ct. App. 1979). Moreover, after-the-fact litigation would be a "most important device" with which to evaluate SRO decisions. *Cf. Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

Second, such an intrusion would conflict with the Congressional scheme of exchange self-regulation. As the Supreme Court recognized in *Silver v. New York Stock Exchange*, 373 U.S. 341, 352 (1963), quoting Justice Douglas during his tenure as Chairman of the SEC, the intention of the Act was "one of 'letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.'" A negligence standard would bring the government's "shotgun" into almost everyday use.

Third, this governmental intrusion, particularly if it did not employ statutory standards of review, would only serve to increase market uncertainty. Every decision made by a SRO would be subject to litigation and judicial review because "any decision the Committee makes will benefit one group of option investors at the expense of another." 633 F. Supp. at 1261-62. The resulting uncertainty benefits no one. *See, e.g.*, J. Pappas & E. Brigham, *Managerial Economics*, 82-86 (3d ed. 1979). As the SEC pointed out in its amicus brief, "[w]hat is essential in such a situation, for the benefit of all investors, is that the decision be made fairly and considered final."

Brawer's argument that OCC's adjustment rule is not discretionary need not detain us long. Although the rule employs the imperative "shall", it also vests the decision

as to what adjustments should be made "in the sole discretion" of the Securities Committee. OCC and AMEX read the rule as allowing the Securities Committee discretion whether to make any adjustments at all. We agree. *See, e.g., Fogel v. Chestnutt*, 533 F.2d 731, 753 (2d Cir. 1975) ("an exchange has a substantial degree of power to interpret its own rules"), *cert. denied*, 429 U.S. 824 (1976); *Intercontinental Industries, Inc. v. American Stock Exchange*, 452 F.2d 935, 940 (5th Cir. 1971) ("Since these are the rules of the Exchange, it should be allowed broad discretion in the determination of their meaning and application."), *cert. denied*, 409 U.S. 842 (1972).

In his complaint, Brawer alleges that the Securities Committee decided not to adjust because unadjusted options were more efficient as instruments of arbitrage and therefore generate increased trading volumes and revenues. Even if Brawer's claim is true, and OCC and AMEX disagree with the factual premise, he has not made out a sufficient claim of bad faith. As we recently recognized in denying a similar claim of bad faith as too remote and speculative, "[i]f such a degree of self-interest were allowed to demonstrate bad faith, then exchange board members . . . would inevitably be subject to bad-faith charges, and the concept of exchange self-regulation would be undermined." *Sam Wong*, 735 F.2d at 672 (quoting 571 F. Supp. 1530, 1545 (S.D.N.Y. 1983)). Nor do we give any weight to Brawer's argument that bad faith may be found because there was no significant distinction between the first Phillips financing scheme, which apparently would have prompted OCC and AMEX to adjust option prices, and the second financing scheme which resulted in no action by OCC and AMEX. The Securities Committee found that the two financing schemes were

sufficiently different to justify different treatment. We decline to substitute our judgment for theirs.[9]

More troublesome is Brawer's claim that OCC and AMEX sterilized their discretion by waiting over three trading days before meeting to decide whether to adjust. This delay was compounded by the allegation that OCC staff members had been stating as early as Monday, March 4 that no adjustment would be made. Brawer claims that by the time the Securities Committee met, they could make no other decision than not to adjust. However, some of that time was apparently spent marshalling information about the second financing scheme. Without this information the Securities Committee would have been subject to a claim of bad faith for failing to be adequately informed.[10] Thus, we are reluctant to require such a Committee to make a "snap" decision. While the issue is close, we think that the mere failure to hold a meeting until three days after the announcement of the second financing scheme does not, without more, amount to a claim of bad faith.

Affirmed.

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[9]We do not mean to foreclose the possibility that disparate treatment of essentially identical financing schemes might be so arbitrary as to constitute constructive bad faith. However, in this case, Brawer has not alleged a sufficient identity between the two plans to induce us to second-guess the Securities Committee's conclusion.

[10]Indeed, Brawer makes just such a claim in the instant case.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

- -x

LEONARD BRAWER,

Plaintiff

- against -

THE OPTIONS CLEARING CORPORATION
and AMERICAN STOCK EXCHANGE, INC.,

Defendants.

- -x

85 Civ. 2148 (LLS)

OPINION and ORDER

A. ARNOLD GERSHON, ESQ.
295 Madison Avenue
New York, New York 10017

Attorney for Plaintiff

SCHIFF, HARDIN & WAITE
7200 Sears Tower
Chicago, Illinois 60606

BURTON R. RISSMAN, ESQ.
Of Counsel

SEWARD & KISSEL
88 Pine Street
New York, New York 10004

M. WILLIAM MUNNO, ESQ.
Of Counsel

Attorneys for Defendant
The Options Clearing
Corporation

LORD, DAY & LORD
25 Broadway
New York, New York 10004

EUGENE F. BANNIGAN, ESQ.
GORDON L. NASH, ESQ.

Attorneys for Defendant
American Stock Exchange, Inc.

LOUIS L. STANTON, D.J.

Defendants The Options Clearing Corporation ("OCC") and American Stock Exchange, Inc. ("AMEX") move pursuant to Fed. R. Civ. P. 12(b) (6) to dismiss the complaint for failure to state a claim upon which relief can be granted, on the ground that there is no private right of action under the applicable provisions of the Securities Exchange Act of 1934 ("Exchange Act" or "Act"), 15 U.S.C. § 78a et seq., under which plaintiff sues; and pursuant to Fed. R. Civ. P. 9(b) for failure to allege fraud or bad faith with the requisite particularity.

Background

The AMEX and OCC are both "self-regulatory organizations" ("SROs") under the Exchange Act, 15 U.S.C. § 78c(a) (26).

The AMEX is registered as a national securities exchange pursuant to § 6 of the Exchange Act, 15 U.S.C. § 78f, and OCC is registered clearing agency pursuant to § 17A of the Act, 15 U.S.C. § 78q-1. Plaintiff is an investor who wrote options on stock issued by Phillips Petroleum Company ("Phillips"). The AMEX provides an exchange market for the trading of options with standard terms, and options on Phillips stock were and are listed and traded at AMEX. All trades in these options are cleared by the OCC.

Plaintiff alleges that at the close of business of March 1, 1985, he held short positions in put options on Phillips stock, under which he was obligated to purchase Phillips stock at the exercise price if the holder of the option required it of him. Between the close of business on March 1, 1985 and the opening of business on March

4, 1985, Phillips, then the target of a hostile takeover, announced a financing scheme or "offer",[1] whereby it would issue a package of debt securities in return for approximately half of its outstanding shares of stock. The Phillips plan was formally announced by a prospectus dated March 4, 1985. While the plaintiff's explanation of the plan's effect upon him is less than clear, it is evident that it caused the price of Phillips stock to fall substantially and thus increased the value of put options and the burdens on plaintiff in meeting his obligations as a writer of puts.

Pursuant to AMEX Rules 902 and 903[2] and OCC By-Laws, Article VI, Section 11 (the "OCC Adjustment Rule"),[3] when a company announces a reorganization that affects its securities, the Securities Committee, consisting of two representatives of each

Exchange of which option contracts in that underlying security are trading and the Chairman of the OCC, shall "make such adjustments in the exercise price . . . as that Committee in its sole discretion determines to be fair" to the holders and writers of option contracts. Upon the announcement by Phillips of its financing plan, defendants' representatives duly met but decided to make no adjustment to the options on Phillips stock.

Plaintiff claims that defendants should have reduced his burdens by an adjustment such as altering his obligation to purchase under the puts he had written, or reducing the exercise price. He alleges that defendants, in failing to adjust option contracts on Phillips stock in response to Phillips's "plan of recapitalization", failed to comply with their own rules and thus violated §§ 6(b), 17A(b) (3) and 19(g)

(1) of the Exchange Act, respectively 15 U.S.C. §§ 78f(b), 78q-1(b) (3) and 78s(g) (1). Although those sections do not expressly grant plaintiff a private right of action against defendants, he argues that such a right of action is implied to allow an injured investor to sue an exchange or clearing agency which fails to comply with its own rules.

Plaintiff relies heavily on Baird v. Franklin, 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944), in which the Court of Appeals for the Second Circuit held that an investor had a private right of action, under the then § 6(b) of the Act,[4] against an exchange for failure to enforce its rules. In that case the defendant New York Stock Exchange had failed to discipline a member broker firm which converted the plaintiff's securities, in violation of the Act and of the

Exchange's Rules. At that time Section 6(b) provided that the SEC would not register an exchange unless its rules provided for appropriate discipline of its members for conduct "inconsistent with just and equitable principles of trade". Section 6(d) required that the exchange be "so organized as to be able to comply with the provisions of this title and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors". Those sections imposed "the two-fold duty upon an exchange of enacting certain rules and regulations and of seeing that they are enforced." Baird at 244. The court observed that a primary purpose of the Act is the protection of the general investing public, and that for that purpose it was necessary to grant investors "individual causes of action to enforce the

statutory duties imposed upon the exchanges." Id., at 245.

At that time, only two sections of the Act, §§ 19 and 23 (15 U.S.C. §§ 78s, 78ff), explicitly imposed sanctions on an exchange for violations, and they provided for the withdrawal of an exchange's registration and suspending or fining its officers or members. The court found both inadequate to protect the defrauded investor, since they were "punitive and remedial measures, rather than compensatory". Ibid. It held that to construe § 6 as granting no private right of action would defeat the statute's purpose of protecting investors. That the statute itself provided no procedure by which the injured investor could proceed was immaterial, because "[i]t is well established that members of a class for whose protection a statutory duty is created may sue for injuries resulting from

its breach and that the common law will supply a remedy if the statute gives none." Ibid; see Texas & P.R. Co. v. Rigsby, 241 U.S. 33 (1916).

Plaintiff contends that Baird supports the conclusion that the present section 6(b), 17A(b) (3) and 19(g) (1) imply he has a right of action against both defendants for their failure to comply with their rules.[5]

For over 30 years this Circuit and other federal courts followed Baird and recognized an implied right of action against an exchange under than § 6(b). See Arneil v. Ramsey, 550 F.2d 774 (2d Cir. 1977); Lank v. New York Stock Exchange, 548 F.2d 61 (2d Cir. 1977); Rich v. New York Stock Exchange, 522 F.2d 153 (2d Cir. 1975); Rich v. New York Stock Exchange, 509 F. Supp. 87 (S.D.N.Y. 1981); Kroese v. New York Stock Exchange, 227 F. Supp. 519

(S.D.N.Y. 1964); Hughes v. Dempsey-Tegeler & Co., [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94, 133 (C.D. Cal. 1974), aff'd, 534 F.2d 156 (9th Cir. 1976), see also Hochfelder v. Midwest Stock Exchange, 503 F.2d 364 (7th Cir.), cert. denied, 419 U.S. 875 (1974) (assumed for purposes of the decision that § 6 created duty in Exchange enforceable in private action, but found no connection between losses and asserted breach of duty, and found in favor of defendant). At least one federal court did not. See Walck v. American Stock Exchange, Inc., 687 F.2d 778 (3rd Cir. 1982); compare, Gustafson v. Strangis, 572 F. Supp. 1154 (D. Minn. 1983) (no private right of action under § 15A against NASD for failure to enforce rules). Significantly, however, every decision in this Circuit following Baird was decided on facts existing prior to the 1975 Amendments

to the Exchange Act. Those Amendments restructured § 6, added new §§ 17A and 19(g), and strengthened the role of the SEC in overseeing the activities of SROs' to ensure that they act in the public interest. See §§ 19(h) and 21(d) and (e). As discussed more fully below, the Amendments end the continuing vitality of Baird.

A second development subsequent to most of the Second Circuit decisions following Baird is a series of Supreme Court decisions setting stricter standards for the implication of private remedies where statutes do not expressly provide them. Thus, although a private damages remedy was held to be implied in former § 6 of the Act, whether one should now be implied from the present statute is a different question.[6]

Discussion

1. The 1975 Amendments

Realizing that the securities industry was faltering under inefficiencies and inadequate regulation and enforcement, Congress amended the Act in 1975. Of significant concern were the SROs' failures to respond appropriately to their statutory obligations. In an effort to preserve their self-regulation yet increase regulatory oversight of SRO activities and function, Congress amended the provisions dealing with SRO's better to define their obligations, see §§ 6, 17A and 19(g), and simultaneously broadened the oversight and enforcement powers of the SEC. Sections 19(h) and 21(d) and (e). Congress

developed comprehensive scheme, contemplating that "self-regulation would be continued, but the SEC would be expected to play a much larger role than it has in the past would be expected to play a much larger role than it has in the past to ensure that there is no gap between self-regulatory performance and regulatory need." Senate Committee on Banking, Housing and Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 23, reprinted in 1975 U.S. Code Cong. & Ad News 179, 181 ("Senate Report").

In the new section 6(b), Congress for the first time expressly required that an exchange, to be registered, must enforce its own rules. That section directs, in relevant part, that -

> (b) an exchange shall not be registered as national securities exchange unless the Commission determines that --
>
> > (1) Such exchange is so organized and has the capacity to be able to

> carry out the purposes of this chapter and to comply, and (subject to any rule or order of the Commission pursuant to section 78q(d) or 78s (g) (2) of this title) to enforce compliance by its members and persons associated with its member with the provisions of this chapter, the rules and regulations thereunder, and the rules of the exchange.

The 1975 Amendments added § 17A to the Act, thus also providing for the first time for registration and SEC regulation of clearing agencies. That section reads, in relevant part, as follows:

> (3) A clearing agency shall not be registered unless the Commission determines that --
>
> > (A) Such clearing agency is so organized and has the capacity to be able to facilitate the prompt and accurate clearance and settlement of securities transactions for which it is responsible, to safeguard securities and funds in its custody or control or for which it is responsible, to comply with the provisions of this chapter and the rules and regulations thereunder, to enforce (subject to any rule or order of the Commission pursuant to section 78g(d) or 78s(g) (2) of this

> title) compliance by it participants with the rules of the clearing agency, and to carry out the purposes of this section.

The SRO's duty to comply with and enforce compliance with their own rules is found in new § 19(g) (1), which directs that --

> (g) (1) Every self-regulatory organization shall comply with the provisions of this chapter, the rules and regulations thereunder, and its own rules, and (subject to the provisions of section 78q(d) of this title, paragraph (2) of this subsection, and the rules thereunder) absent reasonable justification or excuse enforce compliance --
>
> > (A) in the case of a national securities exchange, with such provisions by its members and persons associated with its members;
> >
> > (B) in the case of a registered securities association, with such provisions and the provisions of the rules of the Municipal Securities Rulemaking Board by its members and persons associated with its members; and
> >
> > (C) in the case of a registered clearing agency, with its own rules by its participants.

While making explicit the duty of a SRO to comply with its own rules, Congress simultaneously vested in the SEC the authority and obligation to enforce that duty. Section 19(h) (1) directs:

> (h) (1) The appropriate regulatory agency for a self-regulatory organization is authorized, by order, if in its opinion such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this chapter, to suspend for a period not exceeding twelve months or revoke the registration of such self-regulatory organization, or to censure or impose limitations upon the activities, functions, and operations of such self-regulatory organization, if such appropriate regulatory agency finds, on the record after notice and opportunity for hearing, that such self-regulatory organization has violated or is unable to comply with any provision of this chapter, the rules or regulations thereunder, or its own rules excuse has failed to enforce compliance --
>
> > (A) in the case of a national securities exchange, with any such provision by a member thereof or a person associated with a member thereof;
> >
> > (B) in the case of a registered securities association, with any

> such provision or any provision of tne rules of the Municipal Securities Rulemaking Board by a member thereof or a person associated with a member thereof; or
>
> (C) in the case of a registered clearing agency, with any provision of its own rules by a participant therein.

The SEC is "the appropriate regulatory agency" for the AMEX and OCC, 15 U.S.C. § 78c(a) (34). Section 19(h) (1) was added specifically to enforce § 19(g) and to "significantly increase the regulatory options available to [the SEC] to deal with perceived self-regulatory shortcomings." Senate Report, p. 212. The sanctions provided in § 19(h) (1) "are in addition to suspension and deregistration and are intended to provide more usable sanctions that the SEC's traditional 'big stick,'"[7] Ibid.

Moreover, Congress added §§ 21(d) and (e), which empower the SEC to apply to a

federal court for injunctive relief against violations of its rules by an SRO or its members, and to compel an SRO to enforce compliance by its members, when it appears to the SEC that (1) the SRO is unable or unwilling to take appropriate action or (2) such action is necessary in the public interest or for the protection of investors. Section 21(f); see Senate Report, p. 213.

The addition of these expanded and more flexible powers argues that Congress selected the experience and the expertise of the SEC as the preferred source of remedies for an SRO's shortcomings. Rather than codifying Baird, as plaintiff argues, the revisions strengthened the system of self-regulation:

> Although self-regulation has not always performed up to expectations, on the whole it has worked well, and the Committee believes it should be preserved and strengthened. [The Amendments are] designed to accomplish

> this, not only by clarifying regulatory responsibilities at all levels but also assuring that the self-regulatory organizations follow effective and fair procedures, that their activities are not anticompetitive and that the Commission's oversight powers are ample and its responsibility to correct self-regulatory lapses is unmistakable.

Senate Report, p. 201-2

Thus, the concerns expressed in Baird were recognized and addressed by the 1975 Amendments, whose scheme indicates that Congress did not wish to create compensatory sanctions against a SRO for failure to enforce its rules, as it could easily have done, but instead chose remedial measures with enforcement vested in the SEC.

2. Cort v. Ash and New Limitations on Private Rights of Action

Recent Supreme Court decisions reflect a shift in the Court's approach to the

recurring question whether a federal statute implies a private right of action. "As our recent cases -- particularly Cort v. Ash, 422 U.S. 66, 95 S. Ct. 2080, 45 L. Ed.2d 26 -- demonstrate, the fact that a federal statute has been violated and some person harmed does not automatically give rise to a private cause of action in favor of that person." Cannon v. University of Chicago, 441 U.S. 677, 688 (1979); see also Merrill Lynch, Pierce, Fenner & Smith v. Curran, 456 U.S. 353, 377 (1982) (new approach to implication of private remedies requires more careful scrutiny of legislative intent).

A four-factor test determines whether to infer a private remedy. The factors are whether (a) plaintiff is a member of a class for whose special benefit the statute was enacted; (b) there is any indication of legislative intent to create or deny such a

remedy; (c) the implication of the remedy is consistent with the underlying purposes of the legislative scheme and (d) the cause of action is one traditionally relegated to state law. Cort v. Ash, 422 U.S. at 78. The central inquiry is "whether Congress intended to create, either expressly or by implication, a private cause of action." Touche Ross & Co. v. Redington, 442 U.S. 560, 575 (1979); see Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 15-16 (1979).

(a) Class for whose "especial benefit the statute was enacted"

In determining this factor, the court looks to "the language of the statue itself", Cannon v. University of Chicago, 441 U.S. at 689 (1979). It is clear that both new § 6(b) and § 17A were enacted for

the benefit of investors and the public. Section 6 includes as a prerequisite to the registration of an exchange that its rules "are designed . . . in general, to protect investors and the public interest"; § 6(b)(5); see also § 6(a); Walck v. American Stock Exchange, 687 F.2d at 783. Similarly, § 17A(b)(3) provides that a clearing agency will not be registered unless its rules "are designed . . . in general, to protect investors and the public interest". § 17A(b)(3)(F); see also § 17A(a)(1)(A).

"[T]he mere fact that the statute was designed to protect [investors] does not require the implication of a private cause of action for damages on their behalf . . . The dispositive question remains whether Congress intended to create any such remedy." Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. at 24 (citations

omitted); see also Walck v. American Stock Exchange, Inc., 687 F.2d at 783-84. Supplementing the SEC's enforcement powers, Congress stated that those powers are to be invoked by the SEC when it believes enforcement action is "necessary or appropriate in the public interest" or "for the protection of investors". See §§ 19(h)(1), 19(h)(4) and 21(f). Thus while § 6 and § 17A were indeed enacted for the protection of investors, it is the SEC that will provide that protection.

There is no indication that the statute was enacted to benefit any particular class of investors such as holders or writers of options.

(b) Legislative intent

The second Cort factor looks to the legislative intent. The appropriate

materials to examine are those of the 1975 Amendments. The relevant changes and additions were discussed above, and the concept informing the amendments favors increased supervision and regulation by the SEC, with more sensitive and flexible enforcement capacities, rather than the implication of a private remedy.

None of sections 6, 17A or 19 mention a private remedy Congress provided private remedies under other sections of the Act, §§ 9(e), 16(b) and 18, and "[o]bviously, then, when Congress wished to provide a private damages remedy, it knew how to do so and did so expressly." Touch Ross & Co. v. Redington, 442 U.S. at 572. While the fact that Congress did not expressly so provide here does not foreclose the implication of a private remedy under these sections, see Transamerica v. Lewis, 444 U.S. at 19, the Senate Report shows that

Congress did consider the necessity of improved enforcement and chose to vest that power in the SEC. The Report expresses legislative intent to preserve self-regulation in the industry and to rely on the SEC for enforcement of SROs' performance.

(c) Purpose of the legislative scheme

If an implied remedy would be "necessary or at least helpful to the accomplishment of the statutory purpose", it weighs in favor of implication. Cannon v. University of Chicago, 441 U.S. at 703. Here, to imply a remedy under § 6 would frustrate Congress' purposes.

In Baird, the court found a need for a private right of action because the SEC enforcement powers were not appropriate for protection of the investor. At that time,

and until 1975, a SRO's obligation to comply and enforce compliance with its own rules was not explicit in the statute and the SEC's enforcement powers, to the extent they could be invoked for such purposes, were limited and extreme. See Jennings, "Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission", 29 Law and Contemporary Problems 663, 671-2 and 682 (1964); see also Walck v. American Stock Exchange, 687 F.2d at 784-85. That is no longer the case, since Congress has made explicit the duties of the SROs' and vested broad and flexible powers in the SEC to see that those duties are performed and investors are protected.

The nature of the OCC Adjustment Rule is such that the implication of a private cause of action could undermine the ability of the OCC and AMEX to perform their

functions. The rule vests in the Securities Committee, composed of representatives of the AMEX and OCC, broad discretion to determine to what extent adjustment should be made in fairness to all investors when the issuer's unforeseen transaction affects the underlying security. Necessarily, any decision the Committee makes will benefit one group of option investors at the expense of another. Granting such investors private rights of action against such decisions would invite litigation each time the Committee functioned, undermine the self-regulation contemplated by the Act, and remove options adjustment decisions to federal courts rather than the appropriate agencies.

The Preservation Doctrine

Plaintiff argues that under Merrill Lynch v. Curran, 456 U.S. 353 (1982) the private remedy first implied in Baird should be "preserved" since the legislative history of the 1975 Amendments does not indicate otherwise. Curran holds that where "Congress acts in a statutory context in which an implied private remedy has already been recognized by the courts,. . . the question . . . is whether Congress intended to preserve the pre-existing remedy", not whether Congress intended to create a new remedy. Id., at 378-9.

Curran involved an action for damages by an investor in commodity futures contracts against his brokers for violations of a provision of the Commodity Exchange Act ("CEA") and three actions by speculators in futures contracts against

the New York Mercantile Exchange for its failure to enforce its own rules. The CEA was substantially amended in 1974 to create and grant regulatory and enforcement powers to the Commodity Futures Trading Exchange Commission, among other things. The 1974 amendments, like the original legislation, did not mention private remedies for investors injured by a violation of the CEA. The Court found that, since prior to the amendments "federal courts [had] routinely and consistently . . . recognized an implied private cause of action" under the CEA, id., at 379, and the existence of the private remedy was "well understood", id., at 380, Congress had intended to preserve private remedies for investors against exchanges and its participants for violation of the CEA.

That is not the situation here. Although it appears that an implied cause

of action under § 6 was equally "well understood" prior to the 1975 Amendments, but see Hochfelder v. Midwest Stock Exchange, 503 F.2d 364 (7th Cir.), cert. denied, 419 U.S. 875 (1974), several other factors suggest that Congress did not intend to preserve a private right of action under § 6 when it enacted the 1975 Amendments.

In Curran, the Court found specific evidence in the legislative history, suggesting that Congress was aware of and wished to preserve the implied cause of action, intending the new procedures for relief to supplement rather than supplant the judicial remedy. See id., at 382-88. No such evidence appears here regarding the 1975 Amendments, whose intent is rather to centralize enforcement power in the SEC and preserve the system of self-regulation.

In Curran, amidst a "comprehensive reexamination and significant amendment" of the CEA, Congress had left intact the statutory provisions under which the federal courts had implied a cause of action. Id., at 381. This showed that "Congress affirmatively intended to preserve that remedy." Id., at 381-82. That is not so here. Congress did not leave intact, but changed, the sections on which plaintiff relies. Those sections were restructured or added as part of the legislative scheme described above, defining the SROs' obligations and vesting the SEC with enhanced powers to regulate them.

Accordingly, the observations and reasoning in Curran do not lead to the conclusion that Congress intended to preserve a private cause of action under § 6(d) when it amended the Exchange Act.

Conclusion

Accordingly, it is unnecessary to consider the point of pleading raised by the defendants. For plaintiff's lack of private right of action, the complaint is dismissed.

So ordered.

Dated: New York, New York
April 29, 1986

LOUIS L. STANTON
U. S. D. J.

Footnotes

1. Whether Phillip's activities constituted a plan of recapitalization or a tender offer is disputed by the parties; however, the distinction is not material to this motion.

2. The relevant parts of AMEX Rules 902 and 903 read as follows:

   902(a) Subject to the provisions of Rules 905, 907 and 909, the rights and obligations of holders and writers of option contracts of any class of options dealt in on the Exchange shall be as set forth in the rules of the Options Clearing Corporation.

   903(c) The unit of trading and the exercise price initially established for option contracts of a particular series are subject to adjustment in accordance with the rules of the Options Clearing Corporation. When such adjustment or adjustments have been determined, announcement thereof shall be made by the Exchange and, effective as of the time specified in such announcement, the adjusted unit of trading and the adjusted exercise price shall be applicable with respect to all subsequent transactions in such series of options.

(d) Option contracts shall be subject to adjustments in accordance with the rules of the Options Clearing Corporation.

3. The OCC Adjustment Rule reads in pertinent part as follows:

> SECTION 11. Whenever there is declared a . . . reorganization, recapitalization or reclassification or similar event in respect of any underlying security, the number of outstanding option contracts, the unit of trading and/or the exercise price with respect to all option contracts open for trading in that underlying security shall be adjusted, effective on the "ex-date" of the underlying security in the primary market, in accordance with this Section 11. . . .
>
> (d) In the case of any reorganization, recapitalization, reclassification, or similar event with respect to shares of underlying securities for which adjustment is not provided in any of the foregoing paragraphs of this Section 11, or in the case of any event for which adjustment is provided in one of the foregoing paragraphs but is not considered by the Securities Committee to be appropriate under the circumstances, the Securities Committee shall make such adjustments in the exercise price, trading unit or number of

contracts with respect to the option contracts affected by such event as that Committee in its sole discretion determines to be fair to the holders and writers of such option contracts.

(e) The Securities Committee, in exercising its functions pursuant to paragraphs (c) or (d) of this Section 11 regarding adjustment or option contracts in an underlying security, shall consist of two designated representatives of each Exchange on which option contracts in that underlying security are open for trading and the Chairman of [OCC]. The vote of a majority of the voting members of the Securities Committee shall constitute the action of the Committee. The Chairman of [OCC] shall not be a voting member of the Committee except in the case of a tie vote, in which case the Chairman shall have the right to case a vote to break the tie and shall, for such purpose, be deemed to be a voting member. The members of the Securities Committee need not be Clearing Members or officers or directors of [OCC]. The Securities Committee may transact its business by telephone.

4. Old § 6 provided, in relevant part:

(b) "No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade."

(d) "If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provision of this title and the rules and regulations thereunder that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange."

5. In Baird, the Exchange failed to enforce compliance by a member with the Act and the Exchange's rules. In this action, no member is involved; the Exchange and OCC failed to comply with their own rules. The distinction does not appear to be significant to the determination whether there is a private right of action under § 6 against an exchange. See Bright v. Philadelphia-Baltimore-Washington Stock

Exchange, 327 F. Supp. 495 (E.D. Penn. 1971); cf. New York Stock Exchange, Inc. v. Sloan, 394 F. Supp. 1303 (S.D.N.Y. 1975).

6. The district courts in this Circuit, as well as other federal courts, are similarly reconsidering whether there is an implied remedy under § 6 against a broker-dealer for its violation of an exchange's rules. See Picard v. Wall St. Discount Corp., 526 F. Supp. 1248 (S.D.N.Y. 1981); Jablon v. Dean Witter & Co., 614 F.2d 677 (9th Cir. 1980). The Court of Appeals for the Second Circuit had first implied such a remedy in Colonial Realty Co. v. Bach & Co., 358 F.2d 178 (2d Cir.), cert. denied, 385 U.S. 817 (1966), which held that a private cause of action may exist under § 6 of the Securities Act for violations of some N.Y.S.E. Rules. However, in light of the Supreme Court's new standards for implying remedies, as set forth in Cort v. Ash, 422 U.S. 66 (1975) and subsequent cases, federal courts are re-evaluating whether such a right should be implied and finding that it should not. Picard v. Wall St. Discount Corp., 526 F. Supp. at 1251.

7. In addition to these enforcement powers, the SEC can abrogate or amend any SRO's rules. § 19(c). A SRO must file for approval with the SEC a copy of any proposed rule or rule change, accompanied by a statement with reasons for the proposal. § 19(b). Moreover, the SEC has authority to prescribe rules regulating the activities of clearing agencies if it is necessary in the public interest, to protect

investors or in furtherance of the principles of the statute. § 17A (d) (1).

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the 11th day of December one thousand nine hundred and eighty-six.

Present: HON. J. EDWARD LUMBARD

HON. RICHARD J. CARDAMONE,

HON. LAWRENCE W. PIERCE,

Circuit Judges,

LEONARD BRAWER,

Plaintiff-Appellant,

v.

THE OPTIONS CLEARING CORP AND AMERICAN STOCK EXCHANGE, INC.,

Defendants-Appellees.

No. 86-7416

Appeal from the United States District Court of the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered adjudged and decreed that the JUDGEMENT of said District Court be and it hereby is AFFIRMED in accordance with the opinion of this Court with costs to be taxed against the appellant.

ELAINE B. GOLDSMITH,
CLERK

EDWARD J. GUARDARO,
DEPUTY CLERK

A-56

UNITED STATES COURT OF APPEAL
FOR THE SECOND CIRCUIT

BRAWER
v.
OPTIONS CLEARING CORP.

NOTICE OF MOTION

state type of motion

for extention of time and leave to file the motion out of time

Brief statement of relief requested:

Extension of time to file petition for rehearing with suggestion for rehearing in banc.

By: (Signature of attorney)

Signed name must be printed beneath

A. Arnold Gershon

Appearing for: (Name of party)

Brawer — Appellant for Petitioner: Plaintiff

Date

December 31, 1986

IT IS HEREBY ORDERED that the motion be and it hereby is granted.

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

At a stated Term of the United States Court of Appeals, for the Second Circuit, held at the United States Courthouse in the City of New York, on the eleventh day of February one thousand nine hundred and eighty-seven.

LEONARD BRAWER,
Plaintiff-Appellant,

-against-

THE OPTIONS CLEARING CORPORATION and AMERICAN STOCK EXCHANGE, INC.,
Defendants-Appellees.

No. 86-7416

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the plaintiff-appellant, Leonard Brawer,

Upon consideration by the panel that heard the appeal, it is

ORDERED that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in regular active service and to any other judge on the panel that heard the appeal and that no such judge has requested that a vote be taken thereon.

Elaine B. Goldsmith,
Clerk

Supreme Court, U.S.
FILED
JUN 12 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-1825

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

LEONARD BRAWER,

Petitioner,

vs.

THE OPTIONS CLEARING CORPORATION and AMERICAN STOCK EXCHANGE, INC.,

Respondents.

JOINT BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BURTON R. RISSMAN
ROGER PASCAL*
JOSEPH H. NESLER
SCHIFF HARDIN & WAITE
Attorneys for Respondent The Options Clearing Corporation
7200 Sears Tower
Chicago, Illinois 60606
(312) 876-1000

EUGENE F. BANNIGAN*
GORDON L. NASH
LAURIE E. FOSTER
LORD, DAY & LORD
Attorneys for Respondent American Stock Exchange, Inc.
25 Broadway
New York, New York 10004
(212) 344-8480

* Counsel of Record

36pp

QUESTIONS PRESENTED FOR REVIEW

1. Should this Court issue a writ of *certiorari* to consider the viability of a 40 year old decision of the Court of Appeals, notwithstanding the facts that (1) the Court of Appeals, in this case, has itself expressly declined to consider that decision, (2) the basis for such decision has been undercut by the 1975 Amendments to the Securities Exchange Act of 1934 (the "Act") and recent Supreme Court standards for implying a private right of action and (3) there is no live conflict between such decision and the decisions of other Courts of Appeals?

2. Can an implied right of action against either a national securities exchange or a registered clearing agency for the alleged failure to comply with its own rules be maintained in the absence of an allegation of fraud or bad faith?

3. Was the Court of Appeals' dismissal of this case proper in light of Petitioner's failure to plead facts from which fraud or bad faith could be inferred or to make any showing that such facts could be pleaded?

RULE 28.1 LIST

Respondent The Options Clearing Corporation ("OCC") has no parent companies, subsidiaries (except wholly-owned subsidiaries) or affiliates, except that each of the American Stock Exchange, Inc., the Chicago Board Options Exchange, Inc., the New York Stock Exchange, Inc., the Pacific Stock Exchange, Inc., the Philadelphia Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. owns 1/6 of the outstanding capital stock of OCC and each is entitled to elect one director to OCC's 16-member board of directors.

Respondent American Stock Exchange, Inc. furnishes the following list of parent companies, subsidiaries (except wholly-owned subsidiaries) and affiliates:

Depository Trust Company
National Securities Clearing Corporation
Securities Industry Automation Corporation
The Options Clearing Corporation

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

LEONARD BRAWER,

Petitioner,

vs.

THE OPTIONS CLEARING CORPORATION and AMERICAN STOCK EXCHANGE, INC.,

Respondents.

JOINT BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

STATEMENT OF THE CASE

The Regulatory Context

Respondent American Stock Exchange, Inc. ("AMEX") maintains an exchange market for the trading of standardized options—including put and call options on the common stock of Phillips Petroleum Company ("Phillips"). The operation of options markets by AMEX and other securities exchanges is subject to the plenary rulemaking and supervisory authority of the Securities and Exchange Commission (the "SEC" or "Commission"). To maintain its options trading program, AMEX had to obtain

Commission approval of its pertinent rules pursuant to Section 19(b) of the Act.[1] In order for the Commission to grant such approval, it was required to find that AMEX and its rules met the requirements of Section 6(b) and the other provisions of the Act.[2]

Respondent The Options Clearing Corporation ("OCC") maintains a system for the issuance, settlement, and exercise of options traded on AMEX and other securities exchanges. OCC's clearing system is established under OCC's By-Laws and rules, which were approved by the Commission in 1983 when OCC's registration as a clearing agency under Section 17A(b)(3) of the Act became effective.

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[1] Section 19(b) requires each self-regulatory organization ("SRO") to file with the Commission copies of any proposed rule or rules change accompanied by a concise general statement of its basis and purpose. The Commission is then required to publish notice of the filing, together with the terms or substance of the proposed rule, giving interested persons an opportunity to submit written data, arguments and views. Within certain time constraints, the Commission must either approve the proposed rule or institute proceedings to determine whether it should be disapproved. 15 U.S.C. §§ 78s(b)(1) and (b)(2).

[2] The Commission was required to find, among other things, that AMEX had the capacity to comply, and to enforce compliance, with the provisions of the Act, the rules thereunder, and AMEX's own rules and that its rules met the purposes specified in Section 6(b), including the removal of impediments to, and the perfection of, a free and open marketplace, and, in general, the protection of investors and the public interest. 15 U.S.C. § 78f(b).

The Adjustment Rule

The applicable rules of the Respondents are Article VI, Section 11 of OCC's By-Laws (the "Adjustment Rule") and AMEX Rules 902 and 903(c) and (d). (A. 48-50).[3] However, the AMEX rules do not require specific adjustments of options; they provide only that options traded on AMEX are "subject to" adjustment in accordance with OCC's rules. (A. 49).

Contrary to Petitioner's claim that adjustments are "required" by OCC's By-laws (Petition 5), OCC's Adjustment Rule gives OCC's Securities Committee the "sole discretion" to make adjustments in the case of a "reorganization, recapitalization, reclassification or similar event" in respect of any underlying security. Petitioner's insistence on mischaracterizing this By-law was dealt with succinctly by the Court of Appeals:

> Brawer's argument that OCC's adjustment rule is not discretionary need not detain us long. Although the rule employs the imperative "shall", it also vests the decision as to what adjustments should be made "in the sole discretion" of the Securities Committee. OCC and AMEX read the rule as allowing the Securities Committee discretion whether to make any adjustments at all. We agree. (citations omitted).

(A. 12-13).

Petitioner's stubborn refusal to acknowledge the "sole discretion" language of the Adjustment Rule is matched by his intransigence in claiming, as a matter of undisputed fact, that the Phillips transaction that allegedly damaged Peti-

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[3] Citations in the form of "(A.)" are to the Appendix to the Petition for Writ of *Certiorari*. Citations to the Petition are in the form of "(Petition)".

tioner was a "recapitalization." (Petition 26). Petitioner compounds this error by claiming, in a bold misstatement of the record, that "[n]o one has taken issue with the proposition that the . . . decision not to adjust was clear error" and that "[n]o one has taken issue with the proposition that the failure to adjust resulted in the misallocation of approximately $15 million." (Petition 26).

The Court of Appeals recognized that "[t]he parties disagree as to whether the [transaction] should be designated a 'recapitalization' or an 'exchange offer.'" (A. 8, n.5). The Phillips' prospectus relating to the transaction refers to it throughout as an "Offer" or "Exchange Offer." Similarly, the investment bankers who advised Phillips' Board of Directors referred to the transaction as an "exchange offer." According to the prospectus, Phillips commenced the "Offer" after an earlier proposed transaction, which Phillips referred to as a "recapitalization," had failed to win Phillips' shareholders' approval. As the Court of Appeals recognized, the Securities Committee's decision not to adjust was "in accordance with longstanding policy." (A. 8-9).[4]

Petitioner suggests that the Adjustment Rule may be analogized to anti-dilution provisions contained in certain financial instruments. (Petition 5-7). However, unlike the Adjustment Rule—pursuant to which OCC acts as an

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[4] The market was apparently aware of the Respondents' practice of not adjusting for exchange and tender offers. As Petitioner acknowledged below, the price of Phillips put options rose immediately at the opening of the market on the first business day after Phillips' announcement of the "Offer," prior to any action by the Respondents, and continued to climb throughout the week. (A. 8).

"umpire" of the rights of others—anti-dilution provisions contained in the type of financial instruments described by Petitioner are negotiated between parties acting in their respective self-interests. Moreover, there are vast differences among anti-dilution provisions and no general agreement as to what events should be covered in each case. Indeed, many of the events listed in the American Bar Foundation, Commentaries on Indentures, cited by Petitioner (Petition 5-6), such as "distribution of assets, issuance or sale of other convertible securities, issuance of options [or] issuance or sale of common stock at prices below the current conversion or market price" are often not covered by anti-dilution provisions. The debate over which events should be included in particular provisions is one of the very reasons why the Securities Committee of OCC was granted the latitude of "sole discretion" in determining whether and how adjustments should be made. The OCC By-law on which Petitioner bases his claim does not contain the listing of operative events contained in the Commentaries.

REASONS FOR DENYING THE WRIT

Petitioner's opening hyperbole—apparently designed to exploit current insider-trading headlines—mischaracterizes the very people he has sued. These "powerful and sophisticated professionals" and "lords of the market" who decided that Petitioner should not reap the windfall he sought were, in fact, salaried officers/employees of two SROs who had no affiliation whatever with any member firm of those organizations nor any other investment house. In suggesting that only he stands between the integrity of SROs and chaotic self-interest, he denies the existence and impact of the 1975 Amendments to the Act (the "1975 Amendments") which

were designed to strengthen the Commission's oversight and enforcement powers with respect to SROs and to "insure that [SROs] exercise their delegated governmental power effectively to meet regulatory needs in the public interest and that they do not exercise that delegated power in a manner inimical to the public interest or unfair to private interests." S. Rep. No. 75, 94th Cong., 1st Sess. 34 (1975) (the "Senate Report"), *reprinted in* 1975 U.S. Code Cong. & Admin. News 212. As the Senate Report made clear, the 1975 Amendments "would significantly increase the regulatory options available to [the Commission] to deal with perceived self-regulatory shortcomings." *Id.*

For all intents and purposes, Petitioner refuses to recognize even the existence of the Commission and its oversight role. Petitioner would deny any latitude to the SROs in their function as market "umpires" and, indeed, asserts the right to sue the "umpires" under an ordinary negligence standard, requiring SROs to act at their peril in making the prompt day-to-day decisions in the interest of maintaining fair and orderly markets. Further, Petitioner misapprehends the role which Congress envisioned for SROs, under Commission oversight, in the 1975 Amendments.

The interaction of the 1975 Amendments and this Court's decisions relating to implied rights of action is a matter of some complexity. In the decade since the passage of the 1975 Amendments, no Court of Appeals has addressed the matter as it applies to the actions against SROs for non-enforcement of their own rules. It is telling that the Court of Appeals chose not to do so in this very case. This Court should not offer what would amount to an advisory opinion since, as discussed below, there are good reasons why Courts of Appeals have not addressed the question.

I. NO WRIT SHOULD ISSUE TO REVIEW THE APPLICATION OF *BAIRD* V. *FRANKLIN* TO THIS CASE BECAUSE:

A. There Is No Conflict Among The Circuits.

Petitioner appears to assert that the writ should issue because there is a "live conflict" as to whether *Baird* v. *Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944), "remains good law after the 1975 Amendments to the Act and recent Supreme Court decisions." (A. 5; Petition 12,14). The only "live conflict," however, is between two district courts within the Second Circuit (namely, the district court in this case (*see* 633 F. Supp. 1254 (S.D.N.Y. 1986)) and the district court in *Rich* v. *New York Stock Exchange* (*see* 509 F. Supp. 87 (E.D.N.Y. 1981))). (A. 5).

Rule 17.1(a) of this Court lists, as the first "special and important" reason for granting a writ, the rendering of ". . . a decision in conflict with the decision of another federal court of appeals on the same matter . . . " Although Petitioner clearly relies on this rule in asking this Court to "resolve conflicts concerning whether an investor has an implied claim against an SRO . . . " (Petition 13), he fails to explain that this conflict is among two district courts within the same circuit.

Petitioner also cites *Walck* v. *American Stock Exchange*, 687 F.2d 778 (3rd Cir. 1982), *cert. denied*, 461 U.S. 942 (1983), as a case which has disagreed with *Baird* v. *Franklin*. *Walck*, however, like *Baird*, was decided under the Act as it existed prior to the 1975 Amendments. Thus the "conflict" is a straw man and, at most, an historic curiosity. Whether the decisions of two circuits differed on a proposition which is now moot would seem to be an exercise on which this Court ought not to spend its time.

B. It Would Be Inappropriate For The Court To Review This Case On An Issue Which The Court Below Explicitly Refused To Consider.

This Court has long restrained itself from deciding issues not addressed in the Court of Appeals. *Montana Ry. Co.* v. *Warren*, 137 U.S. 348, 351 (1890); *Old Jordan Mining & Milling Co.* v. *Societe Anonyme Des Mines De Lexington*, 164 U.S. 261, 265 (1896).

> This Court sits as a court of review. It is only in exceptional cases coming here from the federal courts that questions not pressed or passed upon below are reviewed.

Duignan v. *United States*, 274 U.S. 195, 200 (1927). *See also J. Truett Payne Company, Inc.* v. *Chrysler Motors Corporation*, 451 U.S. 557, 568 (1981).

This case is the antithesis of the "exceptional case." The Court of Appeals not only failed to decide the issue which Petitioner raises, but it did so deliberately and explicitly. More importantly, the Court of Appeals' avoidance of the issue was entirely fathomable. First, neither *Baird* nor any other case cited below by Petitioner held that a private right of action could be implied against an exchange or clearing agency based on the SRO's alleged failure to comply with its own rules (as opposed to failure to enforce compliance by members with the SRO's rules). Thus, the Court of Appeals implicitly recognized that, for a private right of action to exist in this case, *Baird* would have to be "*extended* after the 1975 Amendments to support a private cause of action for an SRO's failure to comply with its own rules. . . ." (emphasis added) (A. 5, n.2).

Second, even if the implied private right of action issue had been resolved in favor of Petitioner below, it would not have changed the result below. The Court of Appeals chose,

as this Court should choose, to optimize judicial economy. When it became clear that Petitioner had not adequately alleged bad faith or fraud, it was also clear that an extensive and complex analysis of the recent cases of this Court involving implied private rights of action and the 1975 Amendments themselves would be gratuitous and unnecessary. In this Court, too, Petitioner would fail even if he were to succeed in convincing this Court to revive and extend the application of *Baird* v. *Franklin* to support a private cause of action for an SRO's failure to comply with its own rules, since he has failed adequately to allege fraud or bad faith.[5]

Third, as noted above, this Court has usually found it unwise to venture into issues—particularly complex, highly specialized statutory, and related policy, questions—when the Court of Appeals has not addressed them below.

C. *Baird* v. *Franklin* Has No Vitality Since The 1975 Amendments.

That *Baird* v. *Franklin* is an anachronism not worthy of consideration by this Court becomes apparent upon analysis of the private right of action issue. First, it is undisputed that none of the sections of the Act upon which Petitioner relies provides for a private right of action. Indeed, two of those three sections, 6(b) and 17A(b)(3), do not even proscribe particular conduct as being unlawful, a fact which this Court has found significant. *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 569 (1979). Moreover, there were no allegations in the record below that AMEX or OCC, respectively, failed to comply with these sections.

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[5] The SEC itself urged the Court of Appeals to avoid the implied private right of action issue and to affirm on the basis of Petitioner's failure to allege fraud or bad faith. (A. 4-5).

Second, while Section 19(g)(1) does require SROs to comply with their own rules, the Act expressly provides for *Commission* action to correct any violation of those rules. Also undisputed is the vastly increased and more flexible enforcement authority granted the Commission in the 1975 Amendments. The existence of express judicial or administrative remedies is a strong indication that private remedies should not be implied. *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 19-20 (1979). *See also Touche Ross, supra*, at 571-72; *Cannon* v. *University of Chicago*, 441 U.S. 677, 742 (1979) (Powell, J., dissenting).

Third, Section 19(g)(1) was *added* by the 1975 Amendments. *Baird* v. *Franklin* and other cases under old Section 6(b)[6] obviously cannot stand as authority for an implied right of action under a statutory requirement that was not enacted until 30 years later. In fact, the new Section 6(b) was expressly patterned after Section 15A—the section of the Act which provides for regulation of national securities associations. (Senate Report at 27.) It is significant, therefore, that no case has ever held that there exists an implied private right of action against the National Association of Securities Dealers—the only national securities association regulated under Section 15A—for failure to comply with its own rules. The only case even raising the issue held that no private remedy could be implied under Section 15A. *Gustafson* v. *Strangis*, 572 F. Supp. 1154 (D. Minn. 1983).

Fourth, since the Act never included *any* provision regulating clearing agencies prior to the adoption of Section 17A as part of the 1975 Amendments, it would be impossi-

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[6] *See* Securities Exchange Act of 1934 (Act of June 6, 1934, c. 404, Title 1, Section 6, 48 Stat. 885).

ble to imply a private right of action from *Baird* v. *Franklin* and pre-1975 Section 6(b). Moreover, Congress' express findings with regard to Section 17A would predetermine a negative answer to the question of an implied remedy:

> This subsection [17A(a)(1)] would . . . *centralize in the Commission the authority and responsibility to regulate, coordinate and direct the operations* of all persons involved in the securities handling process toward the goal of a national system for clearance and settlement of securities transactions. (emphasis added)

Senate Report at 122; emphasis added.

Nor should this Court undertake such an implied right analysis here. In the only reported Court of Appeals decision raising the issue, the court below expressly declined to address it. (A. 5). More significantly, the analysis required by this Court's decisions in *Cort* v. *Ash*, 422 U.S. 66 (1975), *Touche Ross*, *supra*, and *Transamerica*, *supra*, would require a section-by-section statutory review under the tests of those decisions. For example, a number of recent decisions have found no implied private rights of action for alleged violations of SRO rules promulgated under other sections of the Act. *See, e.g.*, *Bennett* v. *United States Trust Co. of New York*, 770 F.2d 308 (2d Cir. 1985), *cert. denied*, 106 S. Ct. 800 (1986); *Jablon* v. *Dean Witter & Co.*, 614 F.2d 677 (9th Cir. 1980); *Klock* v. *Lehman Bros. Kuhn Loeb Inc.*, 584 F. Supp. 210 (S.D.N.Y. 1984); *Colman* v. *D.H. Blair & Co., Inc.*, 521 F. Supp. 646 (S.D.N.Y. 1981); *Klitzman* v. *Bache Halsey Stuart Shields, Inc.*, 499 F. Supp. 255 (S.D.N.Y. 1980); *Russo* v. *Bache Halsey Stuart Shields, Inc.*, 554 F. Supp. 613 (N.D. Ill. 1982); *Lenowitz* v. *Philadelphia Stock Exchange*, 502 F. Supp. 428 (E.D. Pa. 1980). The result of such an analysis by this Court, thus, would not settle an important question of federal law with broad application. *See* Rule 17.1(c) of the Rules of this Court. Indeed, it

would not even dispose of this Petitioner's claim since he would then have to face the issue of his failure even to allege fraud or bad faith.

Petitioner strains to find a "conflict" in the application of the "preservation doctrine" of *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 456 U.S. 353 (1982). Once again, as Petitioner's own citation bears witness, the only "conflict" noted by the Second Circuit in this case was the difference between two district courts. (Petition 15; A. 5). Moreover, it cannot be asserted credibly that a duty which did not exist under a pre-amendment statute—the duty of a registered exchange or clearing agency to comply with all of its own rules—could be preserved by the amendment. Additionally, it would not be appropriate to apply the *Curran* preservation mechanism to the extensive modifications of the 1975 Amendments. As noted above, Section 6(b) was entirely rewritten on the pattern of Section 15A of the Act which provides for regulation of national securities associations. Further, prior to the addition of Section 17A to the Act by the 1975 Amendments, there were no cases implying private rights of action against clearing agencies because they were not directly regulated under the Act.

Petitioner concedes as much by arguing that the mere mention of *Baird* v. *Franklin* in a legislative report brings into operation the preservation theory of *Curran*. But the mention of *Baird* v. *Franklin* occurs in a footnote in a study of a subcommittee of an earlier Congress. The footnote relates to text which states that the Commission "does not have the power to directly enforce exchange rules" and that the Act does not "provide any express procedure whereby the Commission can itself see that exchange rules are enforced." Securities Industry Study, Report of the Subcommittees on Securities of the Committee on Banking, Housing and Urban Affairs of the United States Senate,

93rd Cong., 1st Sess. 27, n.21 (Committee Print 1973). Thus, if anything may be inferred from this reference to *Baird* v. *Franklin* it is that Congress identified the deficiencies in the Act which led to *Baird* and acted decisively to remedy them in the 1975 Amendments. The lack of focus of Petitioner's argument is epitomized in his assertion that the 1975 Amendments "codify" *Baird* v. *Franklin* when precisely the opposite is true. (Petition 17).

II. THE WRIT SHOULD NOT BE GRANTED TO REVIEW THE FRAUD OR BAD FAITH STANDARD BECAUSE:

A. There Is No Conflict Among The Circuits As To Whether Actions By An SRO To Comply With Its Own Rules Are Measured By A Fraud Or Bad Faith Standard.

Petitioner attempts to manufacture a conflict—where none exists—as to whether discretionary actions by an SRO to comply with its own rules are measured by a fraud or bad faith standard.

At the outset, it is notable that the Second Circuit gave no indication whatsoever that it perceived that its ruling in this case was either controversial or novel. Indeed, the Court of Appeals stated unequivocally that its decision was consistent with the views expressed by lower courts in the Second Circuit, as well as other circuits, in a line of decisions spanning at least the last forty years involving both stock and commodities exchanges:

> Courts have *consistently* held that "absent allegations of bad faith [an exchange and its officials] may not be held for discretionary actions taken in the discharge of their duties pursuant to the rules and regulations of the Exchange." *P.J. Taggares Co.* v. *New York Mercantile Exchange*, 476 F. Supp. 72, 76 (S.D.N.Y. 1979). We

> recently reaffirmed this view in *Sam Wong & Son, Inc.* v. *New York Mercantile Exchange*, 735 F.2d 653, 670 (2d Cir. 1984) ("*That bad faith is the standard of liability for suits against an exchange with respect to its taking action authorized by applicable law has been established at least since Daniel* v. *Board of Trade, 164 F.2d 815 (7th Cir. 1947)* . . . ."). That these decisions involved suits under the Commodity Exchange Act, 7 U.S.C. § 1 *et seq.*, makes no difference * * * Moreover, courts have applied the bad faith standard in suits alleging violations of discretionary rules by the securities exchanges as well. *See, e.g., Schonholtz* v. *American Stock Exchange, Inc.*, 376 F. Supp. 1089, 1092 (S.D.N.Y.) (dismissing complaint because allegations of exchange rule violations were not coupled with claims of fraud), *aff'd*, 505 F.2d 699 (2d Cir. 1974) (per curiam) and cases cited therein.

(A. 10-11; emphasis added).

Respondents submit that the Second Circuit correctly concluded that the law is settled. The leading case is, in fact, the decision of that Circuit in *Sam Wong & Son, Inc.* v. *New York Mercantile Exchange*, 735 F.2d 653 (2d Cir. 1984), where the plaintiff alleged that the New York Mercantile Exchange, which is an SRO under the Commodity Exchange Act (the "CEA"), 7 U.S.C. § 1 *et seq.*, and its governors and officers violated sections of the CEA and regulations of the Commodity Futures Trading Commission thereunder by failing to monitor the market in certain futures contracts and to take timely action to declare an emergency affecting trading in such contracts. In affirming the lower court's dismissal of Wong's complaint, the Second Circuit stated:

> [E]ven if there is a private cause of action for failure to declare or undue delay in declaring an emergency, this

> portion of Wong's complaint falls [sic] * * * *for want of allegations of bad faith.*

Id. at 670; emphasis added.[7]

Similarly in *P.J. Taggares Co.* v. *New York Mercantile Exchange*, 476 F. Supp. 72, 76 (S.D.N.Y. 1979), the court dismissed a complaint for failing to allege that fraud motivated the commodity exchange's action, holding:

> The Exchange and its officials * * * absent allegations of bad faith may not be held for discretionary actions taken in the discharge of their duties pursuant to the rules and regulations of the Exchange.

To the same effect is *Compania de Salvadorena de Cafe, S.A.* v. *Commodities Futures Trading Commission*, 446 F. Supp. 687, 691 (S.D.N.Y. 1978), where the court dismissed a complaint alleging that a commodity exchange's emergency action violated its rules because the complaint failed to allege bad faith. The court stated: "[t]he discretion of the [exchange] to declare and meet an emergency is * * * without limit except that the [exchange] must act in good faith." *See also, Lagorio* v. *Board of Trade of the City of Chicago*, 529 F.2d 1290, 1291 (7th Cir.), *cert. denied*, 426 U.S. 950 (1976) (court granted defendant exchange summary judgment because the plaintiff failed to allege that the board's discretionary action was taken in bad faith).

In rendering its decision below, the Second Circuit also relied on cases involving securities exchanges such as

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[7]Although the CEA was amended in 1982 to expressly provide for a bad faith standard, the Second Circuit in both this case and *Sam Wong* recognized that the 1982 amendment "merely codified existing case law under that statute." (A. 11). Petitioner concedes this point. (Petition 23).

Schonholtz v. *American Stock Exchange, Inc.*, 376 F. Supp. 1089 (S.D.N.Y.), *aff'd per curiam*, 505 F.2d 699 (2d Cir. 1974), where the district court stated:

> *[N]o case of which we are aware* has found an implied right of action for the violation *per se* of an exchange rule; allegations of such violation have been held to state a claim only where coupled with sufficient allegations of fraud on the investor.

376 F. Supp. at 1092; emphasis added.

Petitioner argues that *Schonholtz* is distinguishable because the court erroneously relied upon a line of cases against members of an exchange for alleged violations of stock exchange rules in which, he admits, the courts have consistently applied a bad faith standard *(e.g., Colonial Realty Corporation* v. *Bache & Co.*, 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966); *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith*, 410 F.2d 135 (7th Cir.), *cert. denied* , 396 U.S. 838 (1969); *McMaster Hutchinson & Co.* v. *Rothschild & Co.*, [72-73 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,541 at 92,585 (N.D. Ill. 1972)).

However, these cases are no less persuasive because they deal with member firms rather than exchanges. It is obvious that the standard should be at least as stringent for claims against SROs as for claims against member firms, in that the exercise of discretion is inherent in the administration by an SRO of its own rules.

In the face of this overwhelming authority mandating a fraud standard for claims involving discretionary action by an SRO, Petitioner, without citation of a single authority, urges again in this Court that the commodities cases are "unreliable precedent." (Petition 23). This argument is unpersuasive. The action taken by the Respondents' Securi-

ties Committee in an effort to maintain a fair and orderly market so closely resembles the type of emergency action taken by commodities exchanges in those cases that the same standard of conduct should be applied.

In support of his position that there are conflicts which require resolution, Petitioner relies exclusively on two cases: *Baird* v. *Franklin, supra*, and *Hughes* v. *Dempsey-Tegeler & Co., Inc.*, 534 F.2d 156 (9th Cir.), *cert. denied*, 429 U.S. 896 (1976).[8] However, neither of these cases involves an alleged failure by an SRO to comply with its own rules. Thus, these cases are plainly distinguishable on their facts and, as such, create no conflict. *See*, Harlan, *Manning the Dikes, supra* at 553 ("[D]ifferences between the Courts of Appeals in two or more circuits will not be accepted as a conflict if they can fairly be accounted for on the basis of variations in the factual situations among the cases involved.").

Baird involved a claim against an SRO for *failing to take action to enforce compliance by* a member firm with the SRO's rules. There the New York Stock Exchange had knowledge that one of its members was guilty of conduct inconsistent with just and equitable principles of trade and had violated numerous of the rules and regulations of the stock exchange. Despite its knowledge of this clear violation of the exchange rules and regulations, the exchange took

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[8]Even assuming, *arguendo*, that the Second Circuit's decision in *Baird* is in conflict with its decision in this case, it cannot possibly create a conflict requiring resolution by this Court. As Justice Harlan once stated "contrary decisions between different panels of the same Court of Appeals will not be considered to present a reviewable conflict, since such differences of view are deemed an intramural matter to be resolved by the Court of Appeals itself." J.M. Harlan, *Manning the Dikes, The Record* 541, 552 (1958). *See also* Supreme Court Rule 17.

absolutely no action to discipline its member. It was this "*complete inaction*" that the Court found to be "a violation of § 6(b) of the Act" (141 F.2d at 244; emphasis added). Thus, *Baird* did not involve an instance of discretionary decision-making by the exchange.

Hughes, like *Baird*, involved a claim that an SRO had *failed to properly supervise a member firm*. In *Hughes*, the New York Stock Exchange could offer no explanation for lifting previously imposed restrictions on a member firm which was in violation of the Exchange's net-capital rule. Although the Ninth Circuit recognized that "[a]s long as the Exchange takes prompt action to investigate alleged violations, and, having ascertained that violations exist, takes action reasonably designed to restore compliance with the rules, courts should not substitute their retrospective judgment concerning the appropriate action" (534 F.2d at 170), it held that the "failure of the Exchange to take constructive action toward the underlying problems of [the member] constitutes a clear breach of its duty." *Id.* at 174.

In sharp contrast, the case at bar is based on an implied right of action under the Act for alleged failure by SROs to comply with their own rules—not a failure to supervise their members or to enforce compliance by their members. Thus, *Baird* and *Hughes*, which arguably establish a negligence standard for alleged inaction on the part of an SRO to enforce compliance with its rules or to properly supervise its members, are wholly inapposite to the instant case. Indeed, no case that we have found involving claims against an SRO for discretionary actions taken pursuant to its rules has applied a lesser standard than that of bad faith or fraud.

Regardless of whether a negligence standard would be appropriate when an SRO has failed to carry out its oversight responsibilities with respect to members, it should not

be applied to claims which seek to "second guess" the discretionary decisions of an SRO in administering its marketplace. Where, as here, the Respondents made a determination pursuant to their rules which specifically authorized them to exercise discretion, the cases make clear that their conduct is to be measured by a bad faith or fraud standard.

The rationale for this rule is that SROs are constantly faced with the responsibility of making decisions and taking action of an immediate nature affecting their markets and the terms and conditions of contracts traded in those markets. Virtually all such decisions made by SROs have the potential for disappointing some investors.[9] If all disappointed investors had the right to sue an exchange or clearing agency merely because they disagreed with the good faith decisions made by its officers and representatives, not only would the legal system be overwhelmed, but courts would constantly be required to substitute their judgments concerning complex market decisions—decisions which

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[9]As noted above, Petitioner blatantly distorts the record in this case when he characterizes Respondents' Securities Committee's action as "whimsical, capricious and disastrous" and states that "[n]o one has taken issue with the proposition that the SROs' decision not to adjust was clear error" and that "the failure to adjust resulted in a misallocation of approximately $15 million." (Petition 26). On the contrary, Respondents vehemently deny these allegations. *See* pp. 3-4, *supra*. This issue was never reached by the Court below simply because, as no bad faith was alleged, its resolution was wholly irrelevant to the Respondents' motion to dismiss.

Congress, in adopting the self-regulatory approach, entrusted to the SROs subject to oversight by the SEC.[10]

The Court of Appeals expressed the logic and fairness of applying a fraud standard:

> There are good reasons why a negligence standard has not been and should not be applied to SRO decision making. First, applying a negligence standard in such cases would force a court to substitute its judgment for that of the experts on the exchange.
>
> * * *
>
> Second, such an intrusion would conflict with the Congressional scheme of exchange self-regulation. As the Supreme Court recognized in *Silver* v. *New York Stock Exchange*, 373 U.S. 341, 352 (1963), quoting Justice Douglas during his tenure as Chairman of the SEC, the intention of the Act was "one of 'letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.'" A negligence standard would bring the government's "shotgun" into almost everyday use.
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> Third, this governmental intrusion, particularly if it did not employ statutory standards of review, would only serve to increase market uncertainty. Every decision made by a SRO would be subject to litigation and

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[10] It is noteworthy that the SEC filed an *amicus curiae* brief on the appeal to the Second Circuit in which it supported Respondents' position that fraud or bad faith was the appropriate standard to be applied to the discretionary decision-making involved in this case. As the Court in *Hughes, supra*, made clear, endorsement by the Commission of an exchange's action is "significant" and should be given "considerable weight." 534 F.2d at 170.

> judicial review because "any decision the Committee makes will benefit one group of option investors at the expense of another." 633 F. Supp. at 1261-62. The resulting uncertainty benefits no one. *See, e.g.*, J. Pappas & E. Brigham, *Managerial Economics*, 82-86 (3d ed. 1979). As the SEC pointed out in its amicus brief, "[w]hat is essential in such a situation, for the benefit of all investors, is that the decision be made fairly and considered final."

(A. 11-12).

B. Section 17A Of The Act Cannot Be Read To Preclude A Fraud Or Bad Faith Standard.

In a fresh lunge at Section 17A of the Act, Petitioner has divined a new reading of that section which he offers for the first time in his Petition in this Court. After conceding reluctantly that, after the enactment of Section 17A, clearing agencies "... operate independently of exchanges" (Petition 27), he focuses on the phrase "prompt and accurate clearance and settlement of securities transactions" and gives it a meaning which cannot be found in the statute itself, its legislative history nor in any other authority. (Petition 28). Apparently, Petitioner suggests that this phrase, which appears throughout Section 17A, deprives OCC, an SRO and registered clearing agency, of any power to apply the Adjustment Rule in any manner inconsistent with Petitioner's supposedly "accurate" reading of it. The argument is seriously flawed in several respects.

First, as Petitioner himself recognizes, the "prompt and accurate" language resulted from the "paperwork crisis" of the late 1960's and has nothing whatever to do with the breadth of an SRO's discretion to interpret and apply its own rules. (Petition 31).

Second, the Adjustment Rule itself provides that the Securities Committee of OCC shall make adjustments which the "... Committee in its *sole discretion* determines to be fair to the holders and writers of such option contracts." (emphasis added) (A. 8, n.4). As noted above, in 1983, OCC's By-laws and rules were approved by the Commission as meeting the requirements of Section 17A(b)(3)(F), which requires that "the rules of the clearing agency are designed to promote the prompt and accurate clearance and settlement of securities transactions." Thus, the By-law which Petitioner claims is confined by the "accurate clearance" language of Section 17A contains a "sole discretion" standard which has, itself, been approved by the Commission as being "designed to promote ... accurate clearance...."[11]

Third, it is settled that SROs have discretion in determining the meaning of their own rules and that courts should not treat such discretion as an issue of statutory interpretation. *Shultz* v. *SEC*, 614 F.2d 561, 570-1 (7th Cir. 1980); *Fogel* v. *Chestnutt*, 533 F.2d 731, 753 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976); *Intercontinental Industries, Inc.* v. *American Stock Exchange*, 452 F.2d 935, 940 (5th Cir. 1971), *cert. denied*, 409 U.S. 842 (1972); *Moses* v. *Burgin*, 445 F.2d 369, 382 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971). This is yet another reason why this Court should not consider the "fraud or bad faith" standard as anything but well settled.

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[11]As noted above, Petitioner's persistent misstatement that an adjustment was "required" by the language of the Adjustment Rule (Petition 30) is a semantic contortion which ignores the phrase "sole discretion" and was emphatically rejected by the Court of Appeals. (A. 12-13).

III. THE DISMISSAL WITH PREJUDICE WAS PROPER.

Petitioner argues that, even if fraud or bad faith is the appropriate standard, dismissal with prejudice was improper at this stage of the proceeding. Petitioner offers no reason whatsoever why this issue is deserving of a grant of *certiorari* by this Court. In any event, as even Petitioner recognizes (Petition 37), if it is apparent that Petitioner could plead no set of facts to support a claim of bad faith or fraud the dismissal was perfectly appropriate.[12]

Such is the case here. Indeed, Petitioner, in a moment of candor, wrote in his brief to the Second Circuit that "there simply are no 'circumstances constituting fraud' . . . to be pleaded," Reply Brief of Plaintiff-Appellant at 23, *Brawer* v. *The Options Clearing Corporation and American Stock Exchange, Inc.*, (2d Cir. 1986) (No. 86-7416). Petitioner's statement below was a direct admission that he has not and cannot meet a fraud standard.

Petitioner now proffers the disingenuous argument that "only two limited purpose depositions" (Petition 35) have been taken and suggests that further discovery might provide him with the facts to sustain a bad faith claim. Petitioner noticed only two depositions and he took two depositions: those of the chairman and chief executive

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[12] Both *McLain* v. *Real Estate Board of New Orleans, Inc.*, 444 U.S. 232 (1980) and *Hospital Building Co.* v. *Trustees of Rex Hospital*, 425 U.S. 738 (1976), relied on by Petitioner, are inapposite. In those cases this Court reversed the district courts' dismissal of antitrust complaints finding sufficient facts pleaded to establish that Respondents' activities had an effect on interstate commerce. In sharp contrast, here there simply are no facts from which bad faith can be inferred.

officer of OCC and the executive vice president of Amex. The so-called "limited purpose" depositions taken by Petitioner were ordered by the district court, at the request of Petitioner, for the specific purpose of enabling Petitioner to explore the facts relating to his claim of bad faith. Thus, the "limited purpose" was the very purpose for which Petitioner now claims he still needs discovery.[13]

Petitioner's claim that there is a "close" question as to the bad faith of the Securities Committee in making its decision with respect to an adjustment is premised primarily on the argument that the Committee delayed taking action because it did not hold a meeting until four days after the announcement of the Phillips tender offer coupled with the unsupported suggestion that, because of the statements made by Respondents' staff during this period, the Commit-

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[13] Petitioner's reliance on *Scheuer* v. *Rhodes*, 416 U.S. 232 (1974), is misplaced. There this Court termed the district court's dismissal of a complaint for lack of subject matter jurisdiction "premature" only after it determined that petitioner should have the opportunity to obtain evidence to support its claims. This Court held:

> When a Federal Court reviews the sufficiency of a complaint, *before the reception of any evidence either by affidavit or admissions*, its task is necessarily a limited one. (emphasis added)

Id. at 236.

Here Petitioner has already had discovery and submitted both deposition testimony and affidavits in support of his fraud claim. The Second Circuit, after considering the evidence, determined that the complaint was fatally flawed. Petitioner should not be permitted to have a second bite at the apple when the facts allegedly constituting the fraud have already been discovered, argued and rejected by the Second Circuit.

tee was forced not to adjust by a desire to avoid lawsuits by disgruntled buyers of Phillips put options.

First, as the Second Circuit recognized (A. 14), the so-called delay was precipitated by the necessity to obtain and review the voluminous prospectus issued by Phillips. The meeting was promptly held following receipt of the offering materials. In any event, the courts have clearly established that SROs are permitted sufficient time to review pertinent information and to deliberate before taking action affecting the interests of investors. For example, in *Sam Wong & Son Inc.* v. *New York Mercantile Exchange*, *supra*, the exchange waited three to four days after the emergency became apparent to hold a meeting and suspend trading in certain futures contracts. The plaintiff challenged the exchange's "delay" in taking the emergency action and the Court held that the plaintiff "could not allege that this delay was taken in bad faith." 735 F.2d at 671. *See also*, *Miller* v. *New York Produce Exchange*, 550 F.2d 762 (2d Cir. 1977) (where the Court held a five day delay in closing the market did not evidence bad faith and "was in keeping with the 'broad and flexible powers' granted the exchange to enable it to insure an orderly market." 550 F.2d at 767.)

Second, the deposition testimony unequivocally demonstrates that the members of the Securities Committee did not take into account possible lawsuits by disgruntled investors when making their decision. Furthermore, if the mere fact that the Respondents might escape lawsuits by one group of investors were sufficient to amount to bad faith, then it is submitted that allegations of "bad faith" could be made with regard to nearly every decision by AMEX or OCC because each time they make a decision affecting the

market it necessarily benefits one group of investors at the expense of another group."[14]

Petitioner also attempts to conjure up a self-interest motive on the part of Respondents by contending that the adjustment decision benefited Respondents by resulting in increased trading volume and revenues. (Petition 35). Here again, *Sam Wong, supra*, is precisely on point. Wong's complaint alleged that the exchange board members were affiliated with member firms which were required to guarantee outstanding contracts in the case of a default. As is usual with most clearing agencies, the clearing members were required to contribute to a fund which could be used to cover defaulted contracts in the case of the financial collapse of an individual firm. The Second Circuit held that such a remote and speculative financial interest was insufficient to amount to an allegation of bad faith:

> [i]f such a degree of self-interest were allowed to demonstrate bad faith, then exchange-board members involved in futures markets would inevitably be subject to bad faith charges, and the concept of exchange self-regulation would be undermined.

735 F.2d at 672 (quoting *Jordan* v. *New York Mercantile Exchange*, 571 F. Supp. 1530, 1545 (S.D.N.Y. 1983)). Respondents in the case at bar had an even lesser interest in the Phillips stock options than the defendants had in the

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[14] Petitioner attempts to liken this case to *Daniel* v. *Board of Trade*, 164 F.2d 815 (7th Cir. 1947), where the Seventh Circuit found bad faith sufficiently alleged. In so doing, Petitioner selectively quotes from that case and deletes the critical allegation that the Respondents there acted "'willfully, maliciously, or for their own personal gain through profits accruing to them through their individual brokerage houses.'" 164 F.2d at 818. Here, of couse, no allegation of personal profit motivation can be sustained.

futures contracts in *Sam Wong*. Only officers of the AMEX and OCC served on the Securities Committee which made the decision; no member firms who might have had a financial interest in the options played any part in making the decision. Furthermore, the depositions, taken at Petitioner's instance, show that arbitrage simply was not considered in making the decision whether to adjust.

In sum, Petitioner, with the benefit of discovery of both Respondents on this very issue, has completely failed to offer any facts from which fraud or bad faith could possibly be inferred.

CONCLUSION

For the reasons stated herein, the Petition for Writ of *Certiorari* should be denied.

Respectfully submitted,

BURTON R. RISSMAN
ROGER PASCAL*
JOSEPH H. NESLER
SCHIFF HARDIN & WAITE
Attorneys for Respondent The Options Clearing Corporation
7200 Sears Tower
Chicago, Illinois 60606
(312) 876-1000

EUGENE F. BANNIGAN*
GORDON L. NASH
LAURIE E. FOSTER
LORD, DAY & LORD
Attorneys for Respondent American Stock Exchange, Inc.
25 Broadway
New York, New York 10004
(212) 344-8480

Dated: June 11, 1987

* Counsel of Record

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No. 86-1825

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

LEONARD BRAWER,

Petitioner,

vs.

THE OPTIONS CLEARING CORPORATION and AMERICAN STOCK EXCHANGE, INC.,

Respondents.

REPLY TO JOINT BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

A. ARNOLD GERSHON
A. ARNOLD GERSHON, P.C.
Attorney for Petitioner
295 Madison Avenue
New York, New York 10017
(212) 684-3033

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1986

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-against-

THE OPTIONS CLEARING CORPORATION
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REPLY TO JOINT BRIEF IN OPPOSITION
TO PETITION FOR A WRIT OF CERTIORARI

The petitioner respectfully submits this reply to address five points raised by the respondents in their joint brief.

1. Timeliness of the § 17A Issue

At page 21 of their brief they assert that the petitioner's argument that § 17A limits the discretion of SROs and precludes a fraud or bad

faith standard is raised "for the first time in his Petition in this Court." Of course, as the respondents should be aware, in my reply brief in the Second Circuit, at page 18, I raised the point that prompt and accurate clearance and settlement were required by § 17A, and at oral argument I argued that it precluded a fraud standard. In addition, I argued the point again in my petition for rehearing in the Second Circuit. Accordingly, the suggestion that this argument comes too late should be rejected.

2. The Discretion Allowed in the Adjustment Rule

The respondents argue that article VI, § 11 of the OCC's bylaws give it unfettered discretion to make adjustment decisions and that since the S.E.C. has approved the bylaw, the

requirement of accuracy contained in § 17A is overridden. Of course, it is an elementary principle of law, typically applied to corporate bylaws and charters, that provisions contained therein are void if they purport to extend authority beyond that permitted by statute. Brooks v. State, 79 A. 790, 800-01 (Del. Supr. 1911). Similarly, I submit that here, even the approval of the S.E.C. fails to empower SROs' bylaws to grant discretion beyond that contemplated by statute.

The respondents, p. 22 n. 11, also note that the Second Circuit "emphatically rejected" the argument that the language of article VI, § 11 did not give the broad discretion claimed by the respondents. So it did, but I submit that its conclusion was based on a misreading of that bylaw. My argument was contained

in the reply brief, and I enclose the relevant portion in the appendix to this brief together with the complete text of article VI, § 11.

3. The Effect of the S.E.C.'s Position

The respondents contend, p. 20 n. 10, that it is "noteworthy" that the S.E.C. supported their position in the Second Circuit. I submit that under the instant circumstances where the position of the S.E.C. concerns the existence of a private right of action and where the S.E.C.'s position is not one which has been long and consistently held, the S.E.C.'s view is entitled to little if any weight. Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, 41 n. 27 (1976).

4. The Troublesome and Close Question

The respondents argue at p. 24 of their joint brief that it is the

petitioner who claims that the issue of fraud or bad faith is "close." As they will recall, it was the Second Circuit that called it "close," and "troublesome" as well. See the appendix to the petition at A-14.

Contained in this close and troublesome issue is the question just who made this decision and how and why. Was it indeed minor functionaries, as the respondents seem to characterize them, Resp. Bf. at page 5, (if the OCC's chairman can be so characterized), or was it more powerful forces? After all, the chairman of the OCC, who is supposedly in charge of this process did not convene the committee but was told to be at his telephone to participate.

5. The Wide Scope of Writs of Certiorari

The respondents contend, at pages

8-9 of their brief, that this court should decline to grant the writ on the question of the continued vitality of Baird v. Franklin, 141 F.2d 238 (2nd Cir.) cert. denied 323 U.S. 737 (1944) on the grounds that the Second Circuit also expressly declined. Of course, when granting a writ of certiorari this court can decide all substantial federal issues determined below. Mercer v. Theriot, 377 U.S. 152, 153-54 (1964). The cases cited by the respondents are inapplicable in that in those cases this court declined to decide questions not raised on appeal below. However, in one case they cite, J. Truett Payne Company, Inc. v. Chrysler Motors Corporation, 451 U.S. 557, 568-69 (1981), this court vacated the judgment of the court of appeals and remanded for it to pass upon the undecided issue.

IN SUMMARY: CONFLICTS, REAL AND IMAGINED

In opposing this petition, the respondents have sought to create the illusion of harmony in the lower courts when in fact those courts are riven with conflict and doubt upon the questions presented by the petitioner.

Similarly, the respondents have sought to promote the appearance of conflict where there is none, such as upon the question whether there is any serious dispute as to whether Phillips Petroleum underwent a recapitalization. As near as I can tell, the respondents' position that it was not a recapitalization is based on the contention that it was instead an exchange offer, relying upon the discredited theory that "pigs is pigs." R.H. Johnson & Co. v. SEC, 198 F.2d

690, 696 (2nd Cir.) cert. denied 344 U.S. 855 (1952). However, since they have yet to offer any explanation (let alone a persuasive one) as to why an exchange offer by an issuer for its own stock must not of necessity also be a recapitalization, as held in the cases I cited in the petition, p. 26, I submit that there is no genuine issue here.

CONCLUSION

The petition for writ of certiorari should be granted, and the judgments below should be reversed.

Respectfully submitted

A. Arnold Gershon
A. Arnold Gershon, P.C.
295 Madison Avenue
New York, N.Y. 10017
212-684-3033

Attorney for Petitioner

Dated: June 19, 1987

APPENDIX

The following is reprinted from pp. 15-18 of the petitioner's reply brief in the Second Circuit:

The OCC and Amex also rely upon the argument that the adjustment rule gives them "the 'sole' discretion to determine when to make an adjustment upon the occurrence of certain events." Ans. Bf. p. 44. The SEC uses the phrase "complete discretion." SEC Bf. p.11.

Their argument fails in analysis. In the main brief, at p. 28, I noted that the adjustment rule said that adjustments "shall" be made and suggested that the word "shall" means "must." That is the usual meaning of "shall." Words and Phrases, "Shall." The word is mandatory unless the contrary "clearly appears." 1A Sutherland Stat Const §25.04 (4th ed. 1985). For example, it has been held not

mandatory for inconsequential time periods, Village of Park Forest v. Fagan, 356 N.E.2d 59 (Ill. 1976), and to avoid unconstitutional constructions. Neither the OCC, the Amex, nor the SEC has refuted or even attempted to explain any reason why the usual meaning of "shall" should be abandoned.

A detailed review of the adjustment rule, §11 of Art. VI of the OCC's bylaws, confirms that the usual rule obtains here. The preambular language of §11 provides that whenever any of the listed events occurs (e.g., stock split, distribution, recapitalization, etc.) the option "shall be adjusted," by adjusting either the number of contracts, trading unit, or exercise price. In subsections (a) and (b) dealing with stock dividends, splits, etc., the adjustment

"shall" be made, and, so far, §11 provides for no discretion of any kind. Discretion first appears in subsection (c), dealing with capital or liquidating distributions or distributions of new classes of stock. It states that "the Securities Committee ... shall determine whether an adjustment is appropriate...." If that committee determines that an adjustment is appropriate, subsection (c) further provides that "either" the exercise price or the trading unit "shall be" adjusted, and, if it is to be the exercise price, "the Securities Committee ... shall determine the value of the distributed property."

I suggest that subsection (c) works in the following way. If a corporation declares the distribution of a new class of preferred stock to the holders of its common, in the

ratio of one share of preferred for one share of common (which common is the underlying stock of a listed option), the committee will first decide whether to adjust. In this they have discretion, but presumably they will ordinarily adjust if the ex date falls before the expiration date, but not after. If they decide to adjust, they next decide how to adjust. They can either decide that the exercise of the option requires delivery of one share of new preferred with each share of old common or that the exercise price shall be reduced by the value of the new preferred. They have the discretion to decide upon one or the other, but they have no other choice and no middle ground; i.e. they cannot do a little of both. If they decide to reduce the exercise price the subsection requires them

to make a separate determination of the value of the new preferred share.

Subsection (d) covers the instant case. It deals with the event of a "reorganization, recapitalization, reclassification or similar event." It provides:

> "the Securities Committee shall make such adjustments in the exercise price, trading unit or number of contracts ... as that Committee in its sole discretion determines to be fair...."

The language "sole discretion" in this subsection (d) refers only to the kind of adjustment and not to whether to adjust. With the exception of subsection (c), concerning distributions, the adjustment requirement is expressed in the imperative mood, i.e., it everywhere else says that an adjustment "shall" be made. In subsection (c), however, it says the committee "shall determine <u>whether</u>"

to adjust, but no such similar language appears in subsection (d). In subsection (c) the committee has discretion as to how to adjust but only as between two mutually exclusive methods. By contrast in subsection (d) the committee has three choices and can select any combination or middle ground. For example, in the instant case, where the Phillips stockholders received three different bonds for their stock, the committee could have either adjusted the trading unit, adjusted the price, or adjusted the trading unit for one bond and the price for two bonds or done it some other way. To express this wide range of choice as to how to adjust, subsection (d) says "sole discretion." If it were meant to give the committee discretion as to whether to adjust, the language would say that the committee "shall determine

whether" to adjust, the same as it does in subsection (c).

I submit that this construction of subsection (d), concerning recapitalizations, is consistent with the balance of the rule and with its purposes.

Article VI, § 11 of the OCC Bylaws:

Whenever there is declared a stock dividend, stock distribution, stock split or reverse split, rights offering, distribution, reorganization, recapitalization or reclassification or similar event in respect of any underlying security, the number of outstanding option contracts, the unit of trading and/or the exercise price with respect to all option contracts open for trading in that underlying security shall be adjusted, effective on the "ex-date" of the underlying security in the primary market, in accordance with

this Section 11. The adjusted exercise price shall be rounded to the nearest 1/8 of a dollar and the adjusted trading unit shall be rounded down to eliminate any fractional share. No adjustment shall be made for cash distributions made out of "earnings and profits" as that term is used in the Federal Internal Revenue Code.

(a) In the case of a stock dividend, stock distribution or stock split whereby one or more whole numbers of shares of the underlying security are issued in respect to each outstanding share, each option contract covering that underlying security outstanding prior to such event shall be increased by the same number of additional option contracts as the number of shares issued with respect to each share of the underlying security, and the exercise price per share in effect

immediately prior to such event shall be proportionately reduced. The unit of trading with respect to each option contract shall remain the same.

(b) In the case of a stock dividend, stock distribution or stock split whereby other than a whole number of shares of the underlying security is issued in respect of each outstanding share, the exercise price in effect immediately prior to such event shall be proportionately reduced, and conversely, in the case of a reverse stock split or combination of shares, the exercise price in effect immediately prior to such event shall be proportionately increased. Whenever the exercise price with respect to an option contract has been reduced or increased in accordance with this paragraph (b), the unit of trading with respect to the option contract shall be proportionately

increased or reduced, as the case may be. If an adjusted unit of trading is rounded down to eliminate a fractional share, the adjusted exercise price shall be further adjusted, to the nearest 1/8 of a dollar, to reflect any diminution in the value of the option contract resulting from the elimination of the fractional share. No adjustment in the number of option contracts outstanding shall be made on account of happening of any of the events for which adjustments are provided in this paragraph.

(c) In the case of any distribution made with respect to shares of underlying securities, other than cash distributions of the character referred to in the third sentence of this Section 11 and other than distributions for which adjustments are provided in paragraphs (a) or (b) of this Section

11, the Securities Committee of the Corporation (as hereinafter defined) shall determine whether an adjustment is appropriate by reason of such event in the interest of fairness to holders and writers of options contracts. Whenever an adjustment is so determined to be appropriate, either (i) the exercise price in effect immediately prior to such event shall be reduced by the value per share of the distributed property, in which event the trading unit shall not be adjusted, or (ii) the trading unit in effect immediately prior to such event shall be adjusted so as to include the amount of property distributed with respect to the number of shares of the underlying security represented by the trading unit in effect prior to such adjustment, in which event the exercise price shall not be adjusted. The

Securities Committee shall determine whether a given event for which adjustment is provided under this paragraph shall result in an adjustment under clause (i) or clause (ii) of the preceding sentence, and, with respect to adjustments under clause (i), it shall determine the value of the distributed property.

(d) In the case of any reorganization, recapitalization, reclassification or similar event with respect to shares of underlying securities for which adjustment is not provided in any of the foregoing paragraphs of this Section 11, or in the case of any event for which adjustment is provided in one of the foregoing paragraphs but is not considered by the Securities Committee to be appropriate under the circumstances, the Securities Committee shall make such adjustments

in the exercise price, trading unit or number of contracts with respect to the option contracts affected by such event as that Committee in its sole discretion determines to be fair to the holders and writers of such option contracts.

(e) The Securities Committee, in exercising its functions pursuant to paragraphs (c) or (d) of this Section 11 regarding adjustment of option contracts in an underlying security, shall consist of two designated representatives of each Exchange on which option contracts in that underlying security are open for trading and the Chairman of the Corporation. The vote of a majority of the voting members of the Securities Committee shall constitute the action of the Committee. The Chairman of the Corporation shall not be a voting member

of the committee except in the case of a tie vote, in which case the Chairman shall have the right to cast a vote to break the tie and shall, for such purpose, be deemed to be a voting member. The members of the Securities Committee need not be Clearing Members or officers or directors of the Corporation. The Securities Committee may transact its business by telephone.